

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~~ Date])

(MARK-UP FROM HONG KONG)

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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 applied, 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 Matter(s) 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 matter(s) 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 decision regarding~~ which type of modified opinion is appropriate will depends upon:
- (a) The nature of the matter giving rise to the modification, i.e. Whether the financial statements are materially misstated or 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 effects or possible effects of the matter giving rise to the modification on the financial statements.
8. The table below illustrates how the auditor’s judgment about the nature, ~~materiality and pervasiveness~~ of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects, affects the type of opinion to be expressed.

<u>Nature of Matter Giving Rise to the Modification</u>	<u>Effects or Possible Effects on the Financial Statements</u>	
	<u>Material but not Pervasive</u>	<u>Pervasive</u>
<u>Financial statements are materially misstated</u>	<u>Qualified opinion</u>	<u>Adverse opinion</u>
<u>Inability to obtain sufficient appropriate audit evidence</u>	<u>Qualified opinion</u>	<u>Disclaimer of opinion</u>

<u>Nature of Matter Giving Rise to the Modification</u>	Affects or Possibly Affects the Financial Statements	<u>Materially but not Pervasively</u>	<u>Materially and Pervasively</u>
	Disagreement with management	<u>Qualified opinion</u>	<u>Adverse opinion</u>

Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion
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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.⁺ 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.~~

*Pervasiveness of the Effects or Possible Effects of a Matter Giving Rise to a Modification*Financial Statements are Materially Misstated

9. The effects of a misstatement, or a combination of misstatements, are pervasive when, in the auditor's judgment, they affect the financial statements to such an extent that the financial statements, taken as a whole, are not prepared in accordance with the applicable financial reporting framework. This situation can arise from a combination of material misstatements affecting several specific elements, accounts or items in the financial statements, or from a material misstatement of a single element, account or item in the financial statements that constitutes an exceptionally large proportion of the financial statements.
10. In judging whether the effects of a misstatement, or a combination of misstatements, are pervasive to the financial statements, the auditor considers the following criteria:
- (a) Whether the effects:

⁺ ~~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.~~

- (i) Relate to a single element, account or item in the financial statements that constitutes an exceptionally large proportion of the financial statements; or
- (ii) Cannot be clearly confined to specific elements, accounts or items in the financial statements, and, where relevant, quantified; and
- (b) If the misstatement, or combination of misstatements, relates to:
 - (i) Disclosures, whether the effects are fundamental to users' understanding of the financial statements; or
 - (ii) Matters other than disclosures, whether the effects represent or could represent a substantial proportion of the financial statements.

11. Determining whether the effects of a misstatement, or a combination of misstatements, represent or could represent a substantial proportion of the financial statements is a matter of professional judgment. In making this determination, the auditor considers the nature of the misstatement or misstatements, the specific elements, accounts or items in the financial statements that are affected, and the magnitude or potential magnitude of the effects in relation to the financial statements as a whole.

Inability to Obtain Sufficient Appropriate Audit Evidence

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

Evaluation of the Pervasiveness of the Effects or Possible Effects of a Matter When Reporting on a Single Financial Statement

13. Where the auditor is engaged to report on a single financial statement (such as a balance sheet) that may or may not form part of a complete set of financial statements, the evaluation of the pervasiveness of the effects or possible effects of a matter giving rise to a modification occurs in the context of the single financial statement on which the auditor has been engaged to report.

Multiple Uncertainties

14. In extremely rare circumstances involving multiple uncertainties, the auditor may conclude that it is not possible to form an opinion on the financial statements as a whole due to the cumulative possible effects of the uncertainties, even though the auditor has obtained sufficient appropriate audit evidence about management's assertions regarding each of the individual uncertainties. Accordingly, in such a situation, the auditor may determine that a disclaimer of opinion is appropriate.

Disagreement with Management

Qualified Opinion

~~12. MOVED TO BECOME PARAGRAPH 21.~~

~~13. MOVED TO AFTER PARAGRAPH 21 THEN DELETED.~~

Adverse Opinion

~~14. MOVED TO BECOME PARAGRAPH 23.~~

~~15. MOVED TO AFTER PARAGRAPH 23 THEN DELETED.~~

~~16. MOVED TO BECOME PARAGRAPH 24.~~

Financial Statements are Materially Misstated

Circumstances in which the Financial Statements are Materially Misstated

15. The auditor may conclude that the financial statements are materially misstated:

(a) Due to a disagreement with management; or

(b) ~~18. The term “disagreement with management” also encompasses the instance where~~ When 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.

Nature of a Disagreement with Management

~~167.~~ 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

~~179.~~ 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.

~~1820. Financial reporting frameworks often contain requirements for the accounting for, and disclosure of, changes in accounting policies. Where the entity has changed its selection of significant accounting policies, a disagreement with management may arise when 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

~~219.~~ 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

~~202.~~ 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; ~~or~~
- (c) In the context of a financial reporting framework designed to achieve fair presentation, the financial statements do not provide the disclosures necessary to enable users to understand the effect of material transactions and events on the information conveyed in the financial statements, for example, in the case of financial statements prepared in accordance with International Financial Reporting Standards (IFRS), the effect on the entity's financial position, financial performance, and cash flows.

Qualified Opinion

212. The auditor should express a qualified opinion when the auditor concludes that the effects of a misstatement, or a combination of misstatements, disagreement with management is are 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 as a whole.~~

22. Example Report 1 in the Appendix illustrates a qualified opinion due to a misstatement, the effects of which are material but not pervasive to the financial statements ~~a disagreement with management.~~

Adverse Opinion

~~1423.~~ The auditor should express an adverse opinion when the auditor concludes that the effects of a misstatement, or a combination of misstatements, disagreement with management is not only material but also are 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 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.

~~1624.~~ Example Report 2 in the Appendix illustrates an adverse opinion due to a misstatement, the effects of which are pervasive to the financial statements ~~a disagreement with management.~~

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

325. 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.

~~3326. The auditor may consider that a~~ 3326. 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 this~~ 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.

~~3427.~~ 3427. 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.~~ accounting records of a significant component based in a foreign or overseas jurisdiction have been appropriated indefinitely by governmental authorities in that jurisdiction.

~~3528.~~ 3528. 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.

~~3629.~~ 3629. 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.

Qualified Opinion

~~230. The auditor should express a qualified opinion. When the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the possible effects on the financial statements of that inability are 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.~~

~~2531.~~ Example Report 3 in the Appendix illustrates a qualified opinion due to an inability to obtain sufficient appropriate audit evidence, the possible effects of which are material but not pervasive to the financial statements.

Disclaimer of Opinion

~~2632.~~ **The auditor should disclaim an opinion on the financial statements** ~~W~~**hen the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the possible effects on the financial statements of that inability is not only material but also are 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.

~~2933.~~ Example Report 4 in the Appendix illustrates a disclaimer of opinion due to an inability to obtain sufficient appropriate audit evidence about a single element in the financial statements. Example Report 5 illustrates a disclaimer of opinion due to an inability to obtain sufficient appropriate audit evidence about multiple elements in the financial statements. In both cases, the possible effects of the inability are pervasive to the financial statements.

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. THIS PARAGRAPH MOVED TO BECOME PARAGRAPH 25.~~

~~33. THIS PARAGRAPH MOVED TO BECOME PARAGRAPH 26.~~

~~34. THIS PARAGRAPH MOVED TO BECOME PARAGRAPH 27.~~

~~35. THIS PARAGRAPH MOVED TO BECOME PARAGRAPH 28.~~

~~36. THIS PARAGRAPH MOVED TO BECOME PARAGRAPH 29.~~

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

~~347. 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 the ~~eat~~ limitation. If management refuses, the auditor should communicate the matter with those charged with governance and consider the implications for the audit and determine 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 or would otherwise be inadequate, the auditor should qualify the opinion or disclaim an opinion. determine the resulting implications as follows:~~

~~(a) If the possible effects of the scope limitation are material but not pervasive to the financial statements, the auditor should qualify the opinion; or~~

~~(b) If the possible effects of the scope limitation are pervasive to the financial statements so that a qualification of the opinion would be inadequate to communicate the gravity of the situation:~~

~~(i) The auditor should resign from the audit, where not prohibited by law or regulation; or~~

~~(ii) If resignation from the audit is not possible, the auditor should 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.~~

~~359.~~ 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, or in jurisdictions where the auditor is appointed for a specific period and is prohibited from resigning before the end of that period. 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

~~4036.~~ 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.

~~3741.~~ **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 applicable financial reporting framework (a “piecemeal opinion”).**

~~3842.~~ 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 opinion or a disclaimer of opinion on the financial statements as a whole, in the same report and with respect to the same financial reporting framework, ~~tends to be~~ is contradictory. It is accordingly not permitted.

~~39.~~ The prohibition in paragraph 37 does not preclude the auditor from issuing opinions on one or more specific elements, accounts or items in the financial statements in other circumstances, provided that:

- (a) The auditor has not expressed an adverse opinion or disclaimed an opinion on the financial statements as a whole; or
- (b) If the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements as a whole, such adverse opinion or disclaimer of opinion:
 - (i) Is not in the same report; or
 - (ii) If it is in the same report, it is not with respect to the same applicable financial reporting framework.

40. Examples of such other circumstances as described in paragraph 39 include:

- In the event the auditor is unable to obtain sufficient audit evidence concerning the entity's opening balances, the possibility of issuing an opinion which is disclaimed on the results of operations and cash flows, but unmodified on the closing financial position (see paragraph 11(c) of ISA 510, "Initial Engagements–Opening Balances").
- The possibility of issuing an unmodified opinion on the financial statements in respect of their proper preparation in accordance with specific legal or regulatory requirements, even though in the same report the auditor has issued an adverse opinion or a disclaimer of opinion on the financial statements as a whole with respect to their fair presentation in accordance with generally accepted accounting principles in the jurisdiction, such as International Financial Reporting Standards (see paragraphs 46-49 of ISA 700 addressing the auditor's legal or regulatory responsibilities to report on other matters).

Communication with Those Charged with Governance

413. Prior to ~~signing~~ ~~forming~~ the ~~report~~ ~~opinion~~, 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.

424. Such communication enables:

- Those charged with governance to be made aware of the expected modification(s) and the reasons (or circumstances) for the modification(s);
- 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
- 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

435. 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.

446. 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~~ **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 Disclaimer **of** Opinion," as appropriate.

45. If the modification results from a material misstatement of the financial statements due to the non-disclosure of information required to be disclosed, the auditor should include in the Basis for Modification paragraph the omitted disclosures, unless impracticable or prohibited by law or regulation. If the omitted disclosures cannot be included, the auditor should describe the nature of the omitted information in the Basis for Modification paragraph.

46. Disclosing the omitted information in the Basis for Modification paragraph would be impracticable if the auditor cannot conclude that the disclosures are free from material misstatement and the auditor would be assuming management's responsibility for the preparation of the financial statements. Assuming management's responsibility would be the case when:

(a) The omitted disclosures have not already been prepared by management or are otherwise not readily available to the auditor; or

(b) In the auditor's judgment, the disclosures are unduly voluminous in relation to the auditor's report (for example, a complete balance sheet or cash flow statement would be considered voluminous in the context of the auditor's report).

47. If the modification results from a material misstatement of the financial statements due to circumstances other than the non-disclosure of information required to be disclosed, the auditor should include in the Basis for Modification paragraph:

~~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~~

~~(a) Where the **disagreement-misstatement** otherwise relates to:~~

~~(i) **S**pecific amounts included, or not accounted for, in the financial statements **(including quantitative disclosures)**, a description of the financial effects of the **disagreement-misstatement**, unless impracticable (for example, the effects on income tax, net income and equity if inventory is overstated); or~~

~~(b) **Where the misstatement relates to incorrect or misleading qualitative narrative disclosures**, an explanation of why the disclosures are **incorrect or misleading-misstated**.~~

If, in subparagraph (a), it is not practicable to quantify the financial effects, the auditor should so state in the Basis for Modification paragraph.

48. If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor **should include in the Basis for Modification paragraph** ~~'s description of the substantive reasons for the modification encompasses~~ the reasons for ~~that~~ **the inability to obtain such audit evidence.**
49. **Even if the auditor has issued an adverse opinion or a disclaimer of opinion, the auditor should describe in the basis for modification paragraph the reasons for any other matters that would have required a modification to the opinion, and the effects thereof.**
- ~~49~~50. An adverse opinion or a disclaimer of opinion does not justify the omission of a description of other identified matters that would require a modification, for example ~~disagreements with management about misstatements regarding~~ 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

- 51~~0~~. When the auditor modifies the audit opinion, the auditor should use the heading “Qualified Opinion,” “Adverse Opinion,” or “Disclaimer of Opinion,” as appropriate, for the modified opinion paragraph.
- 52~~1~~. Inclusion of this paragraph heading makes it clear to the user that the auditor’s opinion is modified and indicates the type of modification.
- 53~~2~~. 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.
- 54~~3~~. Other phrases such as “with the foregoing explanation” or “subject to” are not sufficiently clear or forceful and are not used.
- 55~~4~~. 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.

565. 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 Disclaimer~~rd of~~ 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 Expresses a Qualified or Adverse Opinion

- 57. When the auditor expresses a qualified or adverse opinion, the auditor should amend the description of the auditor’s responsibility to state that the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor’s modified audit opinion.**

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

586. 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~~ **following: “the auditor’s Our** responsibility is to express an opinion on the financial statements based on **conducting** the audit **in accordance with International Standards on Auditing.** Because of the matter(s) described in the Basis for Disclaimer~~rd of~~ Opinion paragraph, however, ~~the auditor was we were~~ not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.”

Effective Date

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

Appendix

Examples of Auditors' Reports with Modifications to the Opinion

Example Report 1: Auditor's report with a qualified opinion due to a misstatement arising from a disagreement with management – overstatement of inventories. The effects of ~~this disagreement with management~~ is the misstatement are deemed to be material but not pervasive to the financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements²

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X~~6~~⁴, 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

² 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.² 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 we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

The company's inventories are ~~recognized-carried~~ in the balance sheet at ~~xxx million~~. We do not agree with management regarding the amounts at which the inventories are stated. ~~With effect from this reporting period, m~~Management has ~~ceased-failed~~ to measure the ~~m inventories~~ at the lower of cost and net realizable value but has measured them solely at cost, 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 ~~xxx million~~ would have been required to write the ~~m inventories~~ down to their net realizable value. Accordingly, €cost of sales would have been increased by ~~xxx million~~, and income tax, net income and shareholders' equity would have been reduced by ~~xxx million~~, ~~xxx million~~ and ~~xxx 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, 20X~~6~~4, 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]

² 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."

Example Report 2: Auditor's report with an adverse opinion due to a misstatement arising from a disagreement with management relating to the non-consolidation of a subsidiary. The effects of this ~~disagreement with management is misstatement are~~ deemed to be ~~not only material but also~~ pervasive to the financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements³

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X~~6~~⁴, 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.⁴ An audit

³ 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.

⁴ 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 adverse audit opinion.

Basis for Adverse Opinion

As explained in Note X, ~~with effect from this reporting period,~~ the company has not ceased to consolidate the financial statements of ~~its~~ subsidiary XYZ Company it acquired during 20X6. 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 XYZ been consolidated financial statements been prepared, ~~the effect on the many elements in the~~ accompanying financial statements would have been materially affected 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, 20X~~6~~+, 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 effects of the inability to obtain sufficient appropriate audit evidence ~~can be clearly described in the auditor's report and, while are deemed to be~~ material, ~~is-but~~ not ~~deemed to be~~ pervasive to the financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements⁵

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X~~6~~⁴, 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.⁶ An audit

⁵ 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.

⁶ 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 qualified audit opinion.

Basis for Qualified Opinion

ABC Company's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is ~~recognized-carried~~ at ~~xxx million~~ on the balance sheet as at December 31, 20X~~6~~1, and ABC's share of XYZ's net income ~~is recognized-at-of xxx-million~~ is included in ABC's income ~~statement~~ for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying ~~value-amount~~ of ABC's investment in XYZ as at December 31, 20X~~6~~1 and ABC's share of XYZ's net income for the year because we were ~~not-given-denied~~ access to the ~~accounting-records~~financial information, management, ~~or-and~~ the auditors of XYZ. Consequently, ~~We~~ were not able to determine whether any adjustments to these amounts 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, 20X~~6~~1, 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]

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 disclaimer~~d~~ of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about a single matter pertaining to the financial statements. ~~Completeness of accounting records cannot be substantiated due to lack of control over sales~~The auditor is unable to obtain audit evidence about the financial information of a joint venture investment that represents over 90% of the company's net assets. The possible effects of this inability to obtain sufficient appropriate audit evidence ~~is~~are deemed to be ~~not~~only material but also pervasive to the financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements⁷

We were engaged to audit the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X~~6~~1, 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 conducting the audit in accordance with International Standards on Auditing. Because of the matter described in the Basis for Disclaimer~~d~~ of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer~~d~~ of Opinion

The company's investment in its joint venture XYZ (Country X) Company is recognized in the company's balance sheet at xxx, which represents over 90% of the company's net assets as at December 31, 20X6. We were unable to obtain the audited financial statements of XYZ in time for the audit as XYZ's auditor resigned in December 20X6. 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

⁷ 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.

performed in time to obtain ~~reasonable assurance that all cash sales were properly recorded~~ audit evidence regarding XYZ's financial information. 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~~ the company's proportional share of XYZ's assets that it controls jointly, its proportional share of XYZ's liabilities for which it is jointly responsible, its proportional share of XYZ's income and expenses for the year, and the elements making up the statements of changes in equity and cash flows.

Disclaimer~~d~~ of Opinion

Because of the significance of the matter described in the Basis for Disclaimer~~d~~ of 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]

Example Report 5: Auditor's report with a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about multiple elements in the financial statements. The auditor is unable to obtain audit evidence about the entity's inventories and accounts receivable. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be pervasive to the financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements⁸

We were engaged to audit the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X6, 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 conducting the audit in accordance with International Standards on Auditing. Because of the matters described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

We were not appointed as auditors of the company until after December 31, 20X6 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at December 31, 20X5 and 20X6 which are stated in the balance sheet at xxx and xxx, respectively. In addition, the introduction of a new computerized accounts receivable system in September 20X6 resulted in numerous errors in accounts receivable. As of the date of our audit report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means

⁸ 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.

accounts receivable included in the balance sheet at a total amount of xxx as at December 31, 20X6. As a result of these matters, we were unable to determine whether any adjustments would be required in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the statements of income, changes in equity and cash flows.

Disclaimer of Opinion

Because of the significance of the matters described in the Basis for Disclaimer of 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]