



International Federation of Accountants

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Agenda Item

7

Committee: IAASB
Meeting Location: New York
Meeting Date: May 22–26, 2006

Modifications

Objectives of Agenda Item

1. To review revised drafts of the proposed ISA 705, “Modifications to the Opinion in the Independent Auditor’s Report”, and the proposed ISA 706, “Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor’s Report” for approval for close off.
2. To review further conforming changes arising from the proposed ISAs 705 and 706.
3. To review the ISA objectives and the disposition of the present tense in the proposed ISAs 705 and 706 under Clarity.

Task Force Composition

The members of the task force are as follows:

- Jan Bo Hansen (Chair, IAASB Member)
- Philip Ashton (IAASB Technical Advisor and former IAASB Member)
- Craig Crawford (IAASB Member)
- Roger Simnett (former IAASB Member)
- Sylvia Smith (IAASB Technical Advisor)

Activities since Last IAASB Discussions

Subsequent to the March 2006 IAASB discussion, the task force held a physical meeting and a conference call in April to discuss the comments received from the IAASB on the first-read drafts (post-exposure) of the proposed ISAs 705 and 706, and to finalize the wording of the close-off drafts.

Main Issues

Proposed ISA 705

1. DESCRIPTION OF PERVASIVENESS IN RELATION TO MISSTATEMENTS

At the March meeting, the task force proposed to describe the meaning of a pervasive disagreement with management in terms of whether the disagreement affects the financial statements to such an extent that they become misleading as a whole. The IAASB recommended that the term

“disagreement with management” be replaced with the broader term “material misstatement,” since it is possible to have a situation where management agrees with the auditor that the financial statements are materially misstated but management refuses to correct them.

The appropriateness of linking the determination of the pervasiveness of a misstatement with whether it has a misleading effect on the financial statements as a whole, was questioned. It was noted that there could be some situations where a material misstatement might cause the financial statements to be misleading but a qualified opinion would still be adequate. In addition, it was noted that the proposed footnote reference to the IFAC Code of Ethics for the term “misleading” only dealt with the auditor’s ethical responsibilities and did not really explain the meaning of “misleading.”

Some IAASB members asked the task force to consider defining the meaning of “misleading.” The task force gave this due consideration and decided that it would be inappropriate to focus narrowly on interpreting this term for the specific purposes of this ISA, as the term is also used in a number of other ISAs (such as ISAs 200 and 700 and the proposed ISA 701). Further, a definition of “misleading” would likely need to include an explanation of how the term interrelates with the concept of freedom from material misstatement for the financial statements as a whole (as addressed in ISAs 200 and 700). This would thus take the issue outside the scope of this project. The task force therefore thought it would be more appropriate to entrust another project (with a broader scope) with the task of establishing a definition of “misleading” that would apply consistently across all ISAs that use the term.

The task force also decided to revise the description of pervasiveness regarding the effects of a misstatement (or a combination of misstatements) in terms of whether 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 links the determination of pervasiveness directly to the main objective of the audit as set out in ISA 200, i.e. to enable the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. The task force noted that this approach would clearly enable the auditor to differentiate between the effects of a misstatement that are merely material from those that are pervasive. This is because in the case of those effects of a misstatement that are material but not pervasive, the auditor would still be able to conclude that, except for the effects of the misstated element, account or item in the financial statements, the rest of the financial statements has been properly prepared in accordance with the applicable financial reporting framework. When the effects of the misstatement are pervasive, however, the entire financial statements are affected, and thus the auditor cannot conclude on any part of the financial statements with regard to proper preparation in accordance with the framework. This approach is set out in paragraph 9 of the revised draft.

2. CRITERIA FOR PERVASIVENESS IN RELATION TO MISSTATEMENTS

The previous draft proposed guidance to assist the auditor in determining whether a qualified or adverse opinion would be appropriate in terms of whether the effects of the material misstatement could be clearly explained in the auditor’s report. A number of IAASB members pointed out at the March meeting that this criterion was somewhat unsatisfactory in that it did not clearly differentiate between material and pervasive situations, and, further, the guidance appeared at times confusing.

The task force reconsidered the guidance and decided to replace this criterion with criteria for pervasiveness in terms of whether the effects of the misstatement relate to a single element, account or item in the financial statements that constitutes an exceptionally large proportion of the financial statements, or whether they cannot be confined to specific elements, accounts or items in the financial statements and (where relevant) quantified. In addition, the determination of the pervasiveness of these effects would also take into account whether they are fundamental to users' understanding of the financial statements (in the case of misstated disclosures), or whether they could represent a substantial proportion of the financial statements (in other cases). What is considered a substantial proportion of the financial statements would ultimately depend on the auditor's professional judgment. This guidance is set out in paragraphs 10 and 11 of the revised draft. The task force believes that the revised guidance provides clearer and more objective criteria that will better enable auditors to apply the ISA consistently in practice.

3. MULTIPLE UNCERTAINTIES LEADING TO A DISCLAIMER OF OPINION

At the March meeting, the task force presented a revised rationale for a disclaimer of opinion arising from the existence of multiple uncertainties, in response to comments received on exposure. The task force argued that to be consistent with the conceptual framework for disclaimers of opinion, the rationale needed to be laid out in terms of the auditor being unable to obtain sufficient appropriate audit evidence about management's assertions regarding the uncertainties. Some IAASB members observed that this situation was not truly an evidence issue, as the need to disclaim an opinion arose more from the combined multiple effects on the financial statements of the interaction of the various uncertainties, such that the auditor would conclude that it is not possible to form an opinion on the financial statements as a whole (i.e. the original exposure draft position). Other members argued against this view on the basis that there should be no case for the auditor to disclaim an opinion if the auditor has obtained sufficient appropriate audit evidence about management's assertions regarding each of the uncertainties and their disclosure.

As a result of the vote taken at the March meeting on this issue, the task force has reflected the majority view of the IAASB in the revised draft, i.e. that it should be the combined multiple effects of the uncertainties that lead to the disclaimer. Given that a situation of multiple uncertainties would likely be rare in practice, the task force decided not to give the issue undue prominence that would detract from the general principles in the proposed ISA. Accordingly, there is no obligation or requirement imposed on the auditor in such a situation. Instead, the proposed ISA provides succinct guidance in paragraph 14 to highlight the issue so that the auditor may determine whether a disclaimer of opinion would be appropriate in the circumstances.

4. DISCLOSURE OF OMITTED INFORMATION IN THE AUDITOR'S REPORT

Based on comments received on exposure and from the IAASB CAG, the task force proposed that the ISA should not require the auditor to include omitted disclosures in the auditor's report that management had failed to disclose. Some IAASB members disagreed with this view, arguing that it would not be in the public interest. Other members agreed with the revised approach proposed by the task force, arguing that doing otherwise would extend the auditor's responsibilities to include management's responsibility for preparing the financial statements, and regulators' responsibility for policing compliance. In response to the latter view, it was noted that the auditor would not really be assuming management's role if the information were readily available.

As a result of the vote taken at the March meeting on this issue, the task force has reflected the majority view of the IAASB in the revised draft, i.e. that the ISA should require the auditor to disclose omitted information in the auditor's report, unless impracticable or prohibited by law or regulation (effectively reinstating the exposure draft position). The relevant requirement is set out in paragraph 45. In response to comments from the IAASB seeking clarification of the guidance on impracticability, the task force has provided further elaboration of the guidance originally provided in the exposure draft, including guidance addressing the situation where the disclosures would be voluminous in relation to the auditor's report. This enhanced guidance is set out in paragraph 46.

Proposed ISA 706

5. CRITERIA FOR EMPHASIS OF MATTER PARAGRAPHS

At the March meeting, the task force highlighted that respondents to the exposure draft had expressed significant concern regarding the proposal that the auditor should emphasize a matter when the criteria specified in the exposure draft are met (i.e. that the matter is both fundamental and unusual). In particular, respondents were concerned that this could lead to an unwarranted proliferation of emphasis of matter paragraphs in auditors' reports. To respond to this concern, the task force proposed to revise the purpose of the requirement to limit the use of emphasis of matter paragraphs to specified circumstances. This would thus avoid the issue of proliferation that would otherwise undermine the effectiveness of this communication tool.

The IAASB noted, however, that the task force's revised wording appeared to convey an inconsistent message. Further, a view was expressed that the auditor should not be prohibited from communicating matters that the auditor believes should be brought to users' attention. Consequently, it was suggested that a consideration of the need to emphasize a matter might be a more appropriate approach in this ISA.

The task force discussed this suggestion and concluded that a requirement for the auditor to consider an emphasis of matter could be problematical, as it would compel the auditor to consider such matters for each and every audit. Accordingly, the task force decided to revise the relevant wording in the proposed ISA such that the auditor would be allowed the flexibility to exercise professional judgment in determining when to emphasize a matter, provided the matter was already presented and disclosed in the financial statements and it met the specified criteria. However, to make it clear that an emphasis of matter is limited only to situations when those criteria have been met, the task force decided to add a safeguard in terms of a bold-letter requirement that a matter not be emphasized unless all the specified criteria have been met (see paragraphs 7 and 8).

In addition, the task force decided that the substance of the paragraphs describing the meaning of the terms "fundamental" and "unusual" in the previous draft could be subsumed into the paragraph setting out the criteria proper (paragraph 7), particularly as the description for "unusual" was relatively brief. Doing so would also avoid the need to separately define or describe the two terms.

6. OTHER MATTER(S) PARAGRAPHS

At the March meeting, the task force noted some confusion during the IAASB discussion regarding the relationship between an other matter(s) paragraph addressed in the proposed ISA 706 and:

- (a) The other matters referred to in paragraph 45 of ISA 700 (Revised) (this paragraph states the following: “Standards, laws or generally accepted practice in a jurisdiction may require or permit the auditor to elaborate on matters that provide further explanation of the auditor’s responsibilities in the audit of the financial statements or of the auditor’s report thereon. Such matters may be addressed in a separate paragraph following the auditor’s opinion.”); and
- (b) The other reporting responsibilities addressed in paragraphs 46-49 of ISA 700 (Revised).

The task force agreed that matters addressed in ISA 700.45 (for example, the “Bannerman” wording added to the auditor’s report in the UK) would fall within the scope of the other matter(s) paragraphs in the proposed ISA 706, as such matters would not be presented and disclosed in the financial statements. The matters addressed in ISA 700.46-49, however, deal with circumstances where the auditor has additional reporting responsibilities that are supplementary to the auditor’s responsibility to express an opinion on the financial statements. Accordingly, the latter do not fall within the scope of the other matter(s) paragraphs in the proposed ISA 706, but instead should be addressed in the second part of the auditor’s report under ISA 700 (Revised). To make this distinction clear and to eliminate any potential confusion, the task force proposes a conforming amendment to delete the guidance in paragraph 45 of ISA 700 (Revised) and to move it to paragraph 20(c) of the proposed ISA 706. In addition, the task force proposes new guidance in paragraph 21 of the proposed ISA 706 to make it clear that this ISA does not deal with the other reporting responsibilities addressed in ISA 700.46-49.

Therefore, in circumstances that would be expected to be rare, the auditor’s report could include an emphasis of matter paragraph and an other matter(s) paragraph, as well as other paragraph(s) addressing the auditor’s other reporting responsibilities.

Other Issues

7. CONFORMING AMENDMENT TO ISA 510.11(c)

In discussing conforming amendments, the task force noted that paragraph 11¹ of ISA 510, “Initial Engagements – Opening Balances,” seemed to allow for a situation where the auditor could issue two separate opinions within the same report on general purpose financial statements. Specifically, ISA 510.11(c) allows the auditor to issue a qualified opinion on the income statement in addition to an unmodified opinion on the balance sheet. The task force’s view was that this needed clarification given the revised requirements and guidance in the proposed ISA 705. The task force’s interpretation of ISA 510.11(c) was that it effectively meant a disclaimer of opinion on the results and cash flows with an unmodified opinion on the financial position. Accordingly, the task force proposes a

¹ ISA 510.11 states the following:

If, after performing audit procedures including those set out above, the auditor is unable to obtain sufficient appropriate audit evidence concerning opening balances, the auditor’s report should include:

- (a) ...
- (b) ...
- (c) **In those jurisdictions where it is permitted, an opinion which is qualified or disclaimed regarding the results of operations and unqualified regarding financial position, for example:**

conforming amendment to ISA 510.11(c) to delete the option of qualifying the opinion on the income statement, and allowing only the possibility of a disclaimer on the results of, and cash flows from, operations (see Agenda 7-E).

8. CONSIDERATION OF THE NEED TO REVISE ISA 710

In deliberating the disclosures that would be necessary in the Basis for Modification paragraph, the task force noted some ambiguity surrounding paragraphs 10-12 of ISA 710, “Comparatives.”²

Specifically, paragraph 12 makes reference in its subparagraphs (a) and (b) to modifying *the report* regarding the corresponding figures instead of modifying the opinion. It also does not discuss what needs to be disclosed in the Basis for Modification paragraph. The task force thinks it is unclear whether ISA 710 requires the auditor to describe the financial effects of the matter on the corresponding figures. The same issue arises with respect to paragraph 15(b).³

The task force briefly discussed whether the financial effects on the corresponding figures should be described in the situations covered by paragraphs 12 and 15(b). Some task force members believed that ISA 710 should be amended to state that when there is a material misstatement that is relevant to the prior year as well as the current year (e.g. because the financial reporting framework requires retrospective application of a requirement), the Basis for Modification paragraph should include quantification of the effects on the corresponding figures as well as on the current year figures, even though the auditor’s opinion would make no reference to the corresponding figures. Other task force members disagreed with this position because for corresponding figures the auditor’s opinion covers only one period.

² Paragraphs 10-12 of ISA 710 state the following:

10. **When the comparatives are presented as corresponding figures, the auditor should issue an auditor’s report in which the comparatives are not specifically identified because the audit opinion is on the current period financial statements as a whole, including the corresponding figures.**
11. The auditor’s report would make specific reference to the corresponding figures only in the circumstances described in paragraphs 12, 13, 15(b), and 16-19.
12. **When the auditor’s report on the prior period, as previously issued, included a qualified opinion, disclaimer of opinion, or adverse opinion and the matter which gave rise to the modification is:**
 - (a) **Unresolved, and results in a modification of the auditor’s report regarding the current period figures, the auditor’s report should also be modified regarding the corresponding figures; or**
 - (b) **Unresolved, but does not result in a modification of the auditor’s report regarding the current period figures, the auditor’s report should be modified regarding the corresponding figures.**

³ Paragraph 15 of ISA 710 states the following:

15. **In such circumstances, the auditor should consider the guidance in ISA 560, “Subsequent Events,” and:**
 - (a) **If the prior period financial statements have been revised and reissued with a new auditor’s report, the auditor should obtain sufficient appropriate audit evidence that the corresponding figures agree with the revised financial statements; or**
 - (b) **If the prior period financial statements have not been revised and reissued, and the corresponding figures have not been properly restated and/or appropriate disclosures have not been made, the auditor should issue a modified report on the current period financial statements, modified with respect to the corresponding figures included therein.**

In view of the above. The task force concluded that potential changes to ISA 710 would represent more than just conforming changes. Accordingly, the task force recommends that the IAASB undertake a separate project to revise ISA 710. Given the need to have a coherent set of revised reporting standards, the task force also believes there is ground for accelerating the revision of ISA 710.

Material Presented

- Agenda Item 7-A Close-Off Draft of the Proposed ISA 705 (Mark-up from Hong Kong)
(Pages 887 – 912)
- Agenda Item 7-B Close-Off Draft of the Proposed ISA 705 (Clean)
(Pages 913 – 934)
- Agenda Item 7-C Close-Off Draft of the Proposed ISA 706 (Mark-up from Hong Kong)
(Pages 935 – 948)
- Agenda Item 7-D Close-Off Draft of the Proposed ISA 706 (Clean)
(Pages 949 – 956)
- Agenda Item 7-E Proposed Further Conforming Changes
(Pages 957 – 962)
- Agenda Item 7-F ISA Objectives and the Disposition of the Present Tense in the Proposed ISAs 705 and 706 under Clarity
(Pages 963 – 966)

Drafts to be Discussed during the Meeting

The task force proposes that the IAASB discuss the markup versions of the close-off drafts during the meeting. Accordingly, in reviewing the material presented, the IAASB should focus on **Agenda Items 7-A and 7-C**.

Action Requested

The IAASB is asked to consider:

- (a) The issues presented and the proposed wording changes set out in the revised drafts, and to approve the proposed ISAs 705 and 706 for close off under the current drafting conventions;
- (b) The further conforming changes presented for approval; and
- (c) The proposed ISA objectives and the disposition of the present tense in the proposed ISAs 705 and 706 under Clarity, and to provide feedback to the task force.

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