The Auditor’s Report on Financial Statements
Proposed new ISA 701

Clean version (Mark-up version begins on page 3)

ISA 701, MODIFICATIONS TO THE INDEPENDENT AUDITOR’S REPORT

1. The purpose of the International Standard on Auditing (ISA) is to establish standards and provide guidance on the circumstances when the independent auditor’s report should be modified and the form and the content of the modifications to the auditor’s report in those circumstances.

2. ISA 700, “The Independent Auditor’s Report on General Purpose Financial Statements” establishes standards and provides guidance on the form and content of the independent auditor’s report on general purpose financial statements when the auditor is able to express an unqualified opinion and no modification to the audit report is necessary. ISA 800, “The Auditor’s Report on Special Purpose Audit Engagements” establishes standards and provides guidance on the form and content of the independent auditor’s report in special purpose audit engagements. This ISA describes how the auditor’s report wording is modified in the following situations:

   **Matters That Do Not Affect the Auditor’s Opinion**
   (a) emphasis of matter

   **Matters That Do Affect the Auditor’s Opinion**
   (b) qualified opinion,
   (c) disclaimer of opinion, or
   (d) adverse opinion.

3. Uniformity in the form and content of each type of modified report will further the user’s understanding of such reports. Accordingly, this ISA includes suggested wording of modifying phrases for use when issuing modified reports.

4. The illustrative reports in this ISA are based on the auditor’s report on general purpose financial statements. The principles relating to the circumstances when the auditor’s report needs to be modified are, however, also applicable to reports on other engagements related to the financial statements.

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1 IAASB revised ISA 700, “The Independent Auditor’s Report on General Purpose Financial Statements” in [XXXX]. This ISA is currently under revision. The only conforming amendments made to this ISA when the revised ISA 700 was issued have been to conform the wording of the auditor’s report in the illustrative examples as necessary to ensure consistency with the illustrative report wording in revised ISA 700 and to specify how modifications to the auditor’s report would be positioned in relation to the auditor’s description of and reporting on any other responsibilities in addition to the auditor’s report on the financial statements.
to the audit of historical financial information, such as the special purpose audit engagements described in ISA 800, “The Auditor’s Report on Special Purpose Audit Engagements”. The illustrative reports would be adapted as appropriate in the circumstances.

**Matters That Do Not Affect the Auditor’s Opinion**

5. In certain circumstances, an auditor’s report may be modified by adding an emphasis of matter paragraph to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such an emphasis of matter paragraph does not affect the auditor’s opinion. The paragraph would preferably be included after the paragraph containing the auditor’s opinion on the financial statements but before the section on any other reporting responsibilities, if any. The emphasis of matter paragraph would ordinarily refer to the fact that the auditor’s opinion is not qualified in this respect.

   [Paragraphs 31 – 34 of ISA 700 would remain unchanged pending the completion of the ISA 701 project.]

10. In addition to the use of an emphasis of matter paragraph for matters that affect the financial statements, the auditor may also modify the auditor’s report by using an emphasis of matter paragraph, preferably after the paragraph containing the auditor’s opinion on the financial statements but before the section on any other reporting responsibilities, if any, to report on matters other than those affecting the financial statements. For example,…[remainder of the paragraph would remain unchanged]

   [Paragraphs 36-39 of ISA 700 would remain unchanged pending the completion of the ISA 701 project.]

15. **Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s) on the financial statements.** Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion on the financial statements and may include a reference to a more extensive discussion, if any, in a note to the financial statements.

   [Paragraphs 41-47 of ISA 700 would remain unchanged pending the completion of the ISA 701 project, other than any conforming wording changes to the illustrative example report wording]
Mark-up showing changes to proposed wording of new ISA 701 presented to IAASB during the July 2003 meeting

ISA 701, MODIFICATIONS TO THE INDEPENDENT AUDITOR’S REPORT

2. The purpose of the International Standard on Auditing (ISA) is to establish standards and provide guidance on the circumstances when the independent auditor’s report on general purpose financial statements should be modified and the form and the content of the modifications to the auditor’s report in those circumstances.

2. ISA 700, “The Independent Auditor’s Report on General Purpose Financial Statements” establishes standards and provides guidance on the form and content of the independent auditor’s report on general purpose financial statements when the auditor is able to express an unqualified opinion and no modification to the audit report is necessary. ISA 800, “The Auditor’s Report on Special Purpose Audit Engagements” establishes standards and provides guidance on the form and content of the independent auditor’s report in special purpose audit engagements. This ISA describes how the auditor’s report wording is modified in the following situations:

Matters That Do Not Affect the Auditor’s Opinion
(b) emphasis of matter

Matters That Do Affect the Auditor’s Opinion
(b) qualified opinion,
(c) disclaimer of opinion, or
(d) adverse opinion.

IAASB revised ISA 700, “The Independent Auditor’s Report on General Purpose Financial Statements” in [XXXX]. This ISA is currently under revision. The only conforming amendments made to this ISA when the revised ISA 700 was issued have been to conform the wording of the auditor’s report in the illustrative examples as necessary to ensure consistency with the illustrative report wording in revised ISA 700 and to specify how modifications to the auditor’s report would be positioned in relation to the auditor’s description of and reporting on any other responsibilities in addition to the auditor’s report on the financial statements.

ISA 700 identifies the basic elements of the auditor’s report. It strongly encourages consistency in the structure, content and wording of the auditor’s report when the audit has been conducted in accordance with the ISAs in order to promote credibility in the global marketplace by making more recognisable those audits that have been conducted in accordance with globally recognised standards. The auditor may encounter circumstances, however, when the auditor believes it is important to emphasise in the auditor’s report certain matters related to procedures performed in the financial statement audit. Paragraph [35] of this ISA notes that the auditor may use an emphasis of matter paragraph to highlight matters other than those affecting the financial statements, preferably after the opinion paragraph (and, as noted in ISA 700 paragraph 49, before the section in the auditor’s report reporting on other reporting responsibilities, if any). The use of emphasis of matter paragraphs will be explored more fully in the revision of ISA 701. In the meantime, auditors are encouraged to use the provision in paragraph [35] in the circumstances described above.
3. Uniformity in the form and content of each type of modified report will further the user’s understanding of such reports. Accordingly, this ISA includes suggested wording of modifying phrases for use when issuing modified reports.

4. The illustrative reports in this ISA are based on the auditor’s report on general purpose financial statements. The principles relating to the circumstances when the auditor’s report needs to be modified are, however, also applicable to reports on other engagements related to the audit of historical financial information, such as the special purpose audit engagements described in ISA 800, “The Auditor’s Report on Special Purpose Audit Engagements”. The illustrative reports would be adapted as appropriate in the circumstances.

Matters That Do Not Affect the Auditor’s Opinion

305. In certain circumstances, an auditor’s report may be modified by adding an emphasis of matter paragraph to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such an emphasis of matter paragraph does not affect the auditor’s opinion. The paragraph would preferably be included after the paragraph containing the auditor’s opinion on the financial statements but before the section on any other reporting responsibilities, if any. The emphasis of matter paragraph would ordinarily refer to the fact that the auditor’s opinion is not qualified in this respect.

[Paragraphs 31 – 34 of ISA 700 would remain unchanged pending the completion of the ISA 701 project.]

3510. In addition to the use of an emphasis of matter paragraph for matters that affect the financial statements, the auditor may also modify the auditor’s report by using an emphasis of matter paragraph, preferably after the paragraph containing the auditor’s opinion on the financial statements but before the section on any other reporting responsibilities, if any, to report on matters other than those affecting the financial statements. For example,…[remainder of the paragraph would remain unchanged]

[Paragraphs 36-39 of ISA 700 would remain unchanged pending the completion of the ISA 701 project.]

4015. Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s) on the financial statements. Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion on the financial statements and may include a reference to a more extensive discussion, if any, in a note to the financial statements.

[Paragraphs 41-47 of ISA 700 would remain unchanged pending the completion of the ISA 701 project, other than any conforming wording changes to the illustrative example report wording]
Note to IAASB

At the July IAASB meeting, the Task Force was asked to review the illustrative reports to ensure that any changes to the report wording proposed for ISA 700 was appropriately reflected in ISA 701. While it would not be appropriate to pre-empt the deliberations of the new 701 Task Force, it would also not be appropriate to leave any blatant inconsistencies between 700 and 701 in the illustrative report wording.

For information, attached below are the illustrative reports that are now included in ISA 700.

On review of the illustrative examples, the Task Force has reconfirmed its view that conforming them should be relatively easy because, with the exception of the modified paragraphs to be added to the report, they tend to refer back to the illustrative wording earlier in the ISA rather than replicate it in each illustrative report.

The only report that requires further consideration is the illustrative example in paragraph 44 of a disclaimer of opinion. In this report, the sentence stating the responsibility of the auditor is omitted and the example observes that the paragraph describing the scope of the audit should be either omitted or amended according to the circumstances. A similar approach is appropriate under the proposed revised auditor’s report.

However, the sentence in the existing audit report stating that the financial statements are the responsibility of the Company’s management remains. The proposed revisions to ISA 700 include replacing this single sentence with a paragraph more fully describing aspects of management’s responsibilities. It is the Task Force’s view that it would not be appropriate to keep the full paragraph describing management’s responsibilities in circumstances when the auditor is expressing a disclaimer. Rather, the single sentence of responsibility that is shown in the illustrative report in paragraph 44 would be more appropriate in those circumstances.

For this reason, it is the Task Force’s recommendation that IAASB leave the illustrative report for the disclaimer of opinion as it is for now, pending further deliberation by the Modified Reports Task Force.

33. An illustration of an emphasis of matter paragraph for a significant uncertainty in an auditor’s report follows:

“In our opinion ... (remaining words are the same as illustrated in the opinion paragraph—paragraph 28 above).

Without qualifying our opinion we draw attention to Note X to the financial statements. The Company is the defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.”

(An illustration of an emphasis of matter paragraph relating to going concern is set out in ISA 570, “Going Concern.”)

44. Illustrations of these matters are set out below.

Limitation on Scope—Qualified Opinion

“We have audited ... (remaining words are the same as illustrated in the introductory paragraph—paragraph 28 above).

Except as discussed in the following paragraph, we conducted our audit in accordance with ... (remaining words are the same as illustrated in the scope paragraph—paragraph 28 above).

We did not observe the counting of the physical inventories as of December 31, 20X1, since that date was prior to the time we were initially engaged as auditors for the Company. Owing to the nature of the Company’s records, we were unable to satisfy ourselves as to inventory quantities by other audit procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to physical inventory quantities, the financial statements give a true and ... (remaining words are the same as illustrated in the opinion paragraph—paragraph 28 above).”

Limitation on Scope—Disclaimer of Opinion

“We were engaged to audit the accompanying balance sheet of the ABC Company as of December 31, 20X1, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. (Omit the sentence stating the responsibility of the auditor).

(The paragraph discussing the scope of the audit would either be omitted or amended according to the circumstances.)

(Add a paragraph discussing the scope limitation as follows:)

We were not able to observe all physical inventories and confirm accounts receivable due to limitations placed on the scope of our work by the Company.
Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements.

Disagreement with Management

46. Illustrations of these matters are set out below.

Disagreement on Accounting Policies—Inappropriate Accounting Method—Qualified Opinion

“We have audited ... (remaining words are the same as illustrated in the introductory paragraph—paragraph 28 above).

We conducted our audit in accordance with ... (remaining words are the same as illustrated in the scope paragraph—paragraph 28 above).

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with International Accounting Standards. The provision for the year ended December 31, 20X1, should be xxx based on the straight-line method of depreciation using annual rates of 5% for the building and 20% for the equipment. Accordingly, the fixed assets should be reduced by accumulated depreciation of xxx and the loss for the year and accumulated deficit should be increased by xxx and xxx, respectively.

In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and ... (remaining words are the same as illustrated in the opinion paragraph—paragraph 28 above).”

Disagreement on Accounting Policies—Inadequate Disclosure—Qualified Opinion

“We have audited ... (remaining words are the same as illustrated in the introductory paragraph—paragraph 28 above).

We conducted our audit in accordance with ... (remaining words are the same as illustrated in the scope paragraph—paragraph 28 above).

On January 15, 20X2, the Company issued debentures in the amount of xxx for the purpose of financing plant expansion. The debenture agreement restricts the payment of future cash dividends to earnings after December 31, 19X1. In our opinion, disclosure of this information is required by ... 3.

In our opinion, except for the omission of the information included in the preceding paragraph, the financial statements give a true and ... (remaining words are the same as illustrated in the opinion paragraph—paragraph 28 above).”

Disagreement on Accounting Policies—Inadequate Disclosure—Adverse Opinion

“We have audited ... (remaining words are the same as illustrated in the introductory paragraph—paragraph 28 above).

We conducted our audit in accordance with ... (remaining words are the same as illustrated in the scope paragraph—paragraph 28 above).

(Paragraph(s) discussing the disagreement).

In our opinion, because of the effects of the matters discussed in the preceding paragraph(s), the financial statements do not give a true and fair view of (or do not ‘present fairly’) the financial position of the Company as of December 20, 19X1, and of the results of its operations and its cash flows for the year then ended in accordance with International Accounting Standards (or [title of financial reporting framework with reference to the country of origin]) (and do not comply with ...).”

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3 Refer to relevant statutes or law.

4 In some circumstances it also may be necessary to refer to a particular jurisdiction within the country of origin to identify clearly the financial reporting framework used.