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Basis for Conclusions: Close Off Documents—ISA 705 (Revised), Modifications to the Opinion in the Independent Auditor’s Report, and ISA 706 (Revised), Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor’s Report

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BASIS FOR CONCLUSIONS:

CLOSE OFF DOCUMENT – ISA 705 (REVISED), MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT

AND

CLOSE OFF DOCUMENT – ISA 706 (REVISED), EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER(S) PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT

This Basis for Conclusions has been prepared by staff of the International Auditing and Assurance Standards Board (IAASB) and does not form part of the close off documents[1] of ISA 705 (Revised), "Modifications to the Opinion in the Independent Auditor's Report," and ISA 706 (Revised), "Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor's Report."

Introduction

1. In September 2006, the IAASB agreed the conventions that it would use in drafting future International Standards on Auditing (ISAs). These conventions are commonly referred to as the IAASB's Clarity conventions.
2. The IAASB issued exposure drafts of certain proposed revised ISAs before it finalized these new conventions. In developing these ISAs for exposure and subsequently revising them as a result of responses received during the consultation, the IAASB applied its old drafting conventions. The revised ISAs, finalized but not issued, are described as the "close off documents", and represent the final ISAs that IAASB would have published had it not changed its drafting conventions as a result of the Clarity project. The Clarity conventions and any necessary redrafting are then applied to the close off documents to arrive at proposed redrafted ISAs that are next exposed for comment on the Clarity changes only (unless in any particular case there is a specific issue on which further consultation (in effect re-exposure) is deemed necessary).
3. This Basis for Conclusions explains the more significant issues raised by respondents on the original exposure drafts of the proposed ISA 705 (Revised) and ISA 706 (Revised) (as drafted following the IAASB's old drafting conventions) issued in March 2005, and how the IAASB has addressed them in finalizing the close off documents of ISA 705 (Revised) and ISA 706 (Revised).
4. This Basis for Conclusions is issued to coincide with the release of the Clarity-redrafted exposure drafts. The effects of the redrafting are explained in the separate explanatory memorandum accompanying those exposure drafts.

[1] Paragraph 2 describes the term "close off" document.

Background

5. When the IAASB undertook to revise the original ISA 700, "The Auditor's Report on Financial Statements," it agreed to restrict the revision to engagements where the auditor is able to express an unmodified opinion on the financial statements and no other modifications to the auditor's report are necessary. To facilitate this revision, the standards and guidance on modifications to the auditor's report (including emphasis of matter paragraphs (EOMs)) in extant ISA 700 were moved to a new ISA, i.e. ISA 701, "Modifications to the Independent Auditor's Report." To increase consistency in reporting among jurisdictions, the IAASB then undertook to revise ISA 701 to enhance the standards and guidance on modifications to the auditor's opinion and EOMs.

6. The project to revise ISA 701 led to the issue of two exposure drafts in March 2005, i.e. the proposed ISA 705 (Revised) ("ED-ISA 705") and ISA 706 (Revised) ("ED-ISA 706"). The comment period closed on July 31, 2005 and 40 comment letters were received from a variety of respondents, including regulators, IFAC member bodies, national standard setters, and firms. The IAASB revised ED-ISA 705 and ED-ISA 706 as a result of these comments and closed off the final ISAs under its old drafting conventions in July 2006. The PIOB expressed its satisfaction that the IAASB had duly followed its due process in August 2006.

7. The revised ISA 705 and ISA 706 form part of the IAASB's suite of reporting standards along with the amended ISA 700, "The Independent Auditor's Report on General Purpose Financial Statements,"[2] and the revised ISA 800, "Special Considerations—Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement."[3]

Issues Common to Both ISA 705 (Revised) and ISA 706 (Revised)

Split Between ISA 705 and ISA 706

8. The extant ISA 701 includes requirements and guidance addressing both modifications to the opinion in the auditor's report and EOMs. In revising this ISA, the IAASB took the view that it would facilitate the goal of consistent application if the ISAs were to differentiate more clearly between matters that give rise to modified opinions (i.e. matters giving rise to qualified or adverse opinions, or disclaimers of opinion), and matters that do not give rise to modified opinions (i.e. emphases of matter and other matters). The IAASB decided that the separation of the related requirements and guidance in ISA 701

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2 Extant ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" was amended as a result of the revision of extant ISA 800, "The Independent Auditor's Report on Special Purpose Audit Engagements." The close off document of ISA 800 (Revised), "Special Considerations—Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement" and related conforming amendments were approved in October 2006.

3 The amended ISA 700, "The Independent Auditor's Report on General Purpose Financial Statements" and the close off document of ISA 800 (Revised) have been redrafted under the Clarity conventions and issued for public comment at the same time as proposed ISA 705 (Revised and Redrafted) and proposed ISA 706 (Revised and Redrafted).

into two distinct ISAs would most appropriately reflect this differentiation. Accordingly, it agreed to split the revised ISA 701 into two new ISAs – ISA 705 and ISA 706.

9. Several respondents disagreed with the IAASB's decision to deal with modifications to the opinion and EOMs/other matters in two separate ISAs. They were in favor of combining the two proposed ISAs into one, arguing that:

   - There had been little evidence of auditors having had difficulty appreciating the structure of the extant ISA 701.
   - The introduction to the extant ISA 701 appeared to set up the distinction between matters that give rise to modified opinions and those that do not in a better way than the two proposed ISAs did separately.
   - There appeared to be much repetition between ED-ISA 705 and ED-ISA 706, which would be eliminated if they were to be combined.
   - With two separate ISAs, practitioners might be confused as to where to find the relevant guidance when faced with a particular reporting matter.
   - The issue of one ISA as opposed to two might help curb any proliferation of unwarranted emphases of matter.
   - Potential confusion between "uncertainties" arising from an inability to obtain sufficient appropriate audit evidence, and significant uncertainties giving rise to emphases of matter, could be eliminated if there were to be only one ISA.
   - The specific case of a disclaimer of opinion for multiple uncertainties involves circumstances that affect both proposed ISAs, and so this would be better dealt with if there were only one document.

   Some of these respondents went further and recommended that there be only one ISA incorporating the requirements and guidance in ISAs 700, 705 and 706, so that all the requirements and guidance dealing with reporting would be in one place (notwithstanding that ISA 800 would continue to be separate). The majority of respondents, however, agreed with the proposal.

10. The IAASB was not persuaded that merging the two proposed ISAs would achieve a better outcome and concluded that, overall, the benefit of being better able to distinguish between modifications to the auditor's opinion and EOMs/other matters through distinctive and separate ISAs outweighed the perceived drawbacks. Accordingly, the separation of the requirements and guidance into ISA 705 and ISA 706 has been retained.

Use of Mandatory Subheadings in Auditors' Reports

11. The explanatory memorandum to ED-ISA 705 and ED-ISA 706 asked respondents to comment on whether the use of mandatory subheadings would be desirable in auditors' reports that contained modifications to the opinion, or EOMs/Other Matter(s) paragraphs. The overwhelming majority of respondents supported the use of mandatory subheadings to highlight modifications to the opinion, or EOMs or other matters.

12. A number of respondents, however, suggested that further refinement to the proposed subheadings might be appropriate. In particular, with respect to qualifications:

    - They argued that the use of a single type of subheading might lead users to consider all qualifications as having the same importance, for example, a qualification due to an inability to obtain audit evidence imposed by circumstances might be viewed as being just as important as a serious disagreement with management.
    - They considered it desirable to distinguish, by means of the subheading, between qualified opinions arising from disagreement with management and those arising from an inability to obtain sufficient appropriate audit evidence.

13. The IAASB did not agree with these suggestions as more detailed subheadings could provide a disincentive for the users of the financial statements to read the auditor's report in full. In addition to their potential for being lengthy and unwieldy, more detailed subheadings could also undermine the effectiveness of the auditor's explanations in the Basis for Modifications paragraphs. Accordingly, the IAASB concluded that no changes should be made to the proposed subheadings.

Issues Specific to ISA 705 (Revised)

Applicability of ISA 705 to Engagements Other than Those Dealing with Reporting on the Fair Presentation of General Purpose Financial Statements

14. The introduction to ED-ISA 705 stated that the standards and guidance in the ISA are to be applied in circumstances when the auditor modifies the opinion paragraph in the auditor's report issued as a result of an audit of a complete set of general purpose financial statements or a special purpose audit engagement. One respondent noted that ED-ISA 705 did not, in fact, appear to address engagements other than those dealing with reporting on the fair presentation of general purpose financial statements. Specifically, the respondent argued that given that the proposed requirements and guidance on the form of the modified opinion paragraph dealt only with fair presentation of financial statements, ED-ISA 705 did not appear to address the nature of a modification when the financial reporting framework:

    - Was not designed to achieve fair presentation (i.e., a compliance framework); or
    - Was designed to achieve the fair presentation of something other than the financial position, financial performance and cash flows of an entity (i.e., special purpose frameworks leading to fair presentation).

15. This was not the IAASB's original intention as the introduction to ED-ISA 705 made clear that the scope of the ISA included engagements to report on historical financial information other than a complete set of general purpose financial statements prepared in accordance with a fair presentation financial reporting framework. In addition, with the exception of summary audited financial statements which are dealt with under the revised ISA 805, "Engagements to Report on Summary Financial Statements," the requirements and guidance in ED-ISA 705 were intended to be applicable to an audit of historical

financial information generally, whether the auditor was engaged to audit general purpose financial statements or other historical financial information.

16. The IAASB, however, agreed that further clarification was necessary. Accordingly, it has revised the introductory section to make it clear that the requirements and guidance in the ISA are to be applied to an engagement to report on a complete set of general purpose financial statements prepared in accordance with a fair presentation framework (ISA 700), and that these requirements and guidance are to be applied, adapted as necessary, in the circumstances of an engagement to report on other non-summary historical financial information[4] (see paragraphs 2-3[5]).

Meaning of "Pervasiveness"

17. ED-ISA 705 proposed guidance to assist the auditor in determining the pervasiveness of a matter giving rise to an adverse opinion or a disclaimer of opinion. It explained that the auditor would consider the following criteria in determining the pervasiveness of a matter:

    (a) The extent to which a disagreement with management on the financial statements or an inability to obtain sufficient appropriate audit evidence can be (i) related to specific items in the financial statements and (ii) quantified; and

    (b) Whether the effect of the disagreement with management can be clearly explained in the auditor's report.

18. Several respondents commented that these criteria should be further clarified and strengthened. They argued, in particular, that the first criterion would exclude material misstatements relating to qualitative disclosures that cannot be quantified, and the second criterion appeared to exclude circumstances where the effect of a disagreement with management or the potential effect of a scope limitation can be clearly explained in the auditor's report but a mere qualification would be inadequate.

19. The IAASB accepted these comments and agreed that the explanation of the meaning of pervasiveness needed revision. The following key points were noted and refinements made accordingly:

    - A disagreement with management relating to amounts in the financial statements is pervasive when the effects of the misstatement *cannot* be quantified and confined to particular line items that do not represent a significant proportion of the financial statements. A disagreement with management relating to disclosures in the financial statements is pervasive when the effects of the misstatement *cannot* be confined to particular disclosures not fundamental to the financial statements.

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4 After the IAASB approved the close off document of ISA 705 (Revised) in July 2006, extant ISA 700 was amended as a result of the revision of extant ISA 800 (see footnote 2). The scope of the amended ISA 700 now includes general purpose financial statements broadly and is no longer limited to general purpose financial statements prepared in accordance with a fair presentation framework only.

5 Paragraph numbers refer to the close off documents unless otherwise noted.

- The suggested description of pervasiveness should be simplified by avoiding the multiple use of negative clauses in the discussion of a disagreement with management.
- In response to comments made by some respondents, the description of pervasiveness should refer to the more inclusive concept of *material misstatements* of the financial statements instead of a disagreement with management, as material misstatements leading to a qualified or adverse opinion may be caused by circumstances other than a disagreement with management.
- The *misstatements* would be deemed to be pervasive to the financial statements when individually or in the aggregate they are material and cannot be confined to specific elements, accounts or items in the financial statements, or, if confined, they represent or could represent a substantial proportion of the financial statements (see paragraph 9).
- In relation to disclosures, the misstatements would be deemed to be pervasive when individually or in the aggregate they are material and the misstated disclosures are fundamental to users' understanding of the financial statements (see paragraph 10).
- An inability to obtain sufficient appropriate audit evidence is pervasive when the potential effects of that inability *cannot* be confined to particular items that in aggregate (a) entail a quantifiable maximum potential misstatement not constituting a significant proportion of the financial statements proper, or (b) represent disclosures not fundamental to those financial statements.

20. The IAASB took the view that what would be considered a substantial proportion of the financial statements would ultimately depend on the auditor's professional judgment in the circumstances.

21. In relation to an inability to obtain sufficient appropriate audit evidence, the IAASB further agreed to align the description of pervasiveness with the revised description in relation to misstatements. Thus, such an inability would be deemed material and pervasive when the possible effects of the inability cannot be confined to specific elements, accounts or items in the financial statements or, if confined, those possible effects could represent a substantial proportion of the financial statements (see paragraph 11).

22. The IAASB believes that the revised guidance on pervasiveness provides clearer and more objective criteria that will better enable auditors to apply the ISA consistently in practice.

23. The IAASB agreed to move this guidance towards the front of the ISA to respond to concerns from several respondents that although the term "pervasiveness" has such importance and is used so extensively throughout the ISA, an explanation of its meaning did not appear until much later in the exposure draft.

24. Finally, a number of respondents suggested that a definition of pervasiveness should be provided, both in the proposed ISA and in the Glossary of Terms. The IAASB did not

agree that it would be appropriate to turn the revised descriptions of pervasiveness into definitions, given that they inherently call for the application of professional judgment.[6]

Multiple Uncertainties Leading to a Disclaimer

25. ED-ISA 705 proposed to retain guidance in the extant ISA 701 to explain that in extreme circumstances involving multiple uncertainties, the auditor may conclude that the cumulative nature and possible effect of the multiple uncertainties are such that it is not possible to form an opinion and, accordingly, the auditor expresses a disclaimer of opinion. The IAASB's rationale was that in those circumstances the cumulative nature and possible effect of the uncertainties would altogether become sufficiently material and pervasive, leading to an impossibility for the auditor to form an opinion on the financial statements (even though, individually, each uncertainty would not give rise to a disclaimer of opinion). The explanatory memorandum to the exposure draft asked for respondents' views as to whether this guidance might make it difficult for practitioners to know when to include an emphasis of matter paragraph and when to disclaim an opinion in cases of multiple uncertainties.

26. The overwhelming majority of respondents supported the retention of this guidance. Two respondents, however, argued that the cumulative nature and possible effect of the multiple uncertainties does not *in itself* cause the auditor to disclaim an opinion. Rather, they were of the view that it is the inability to obtain sufficient appropriate audit evidence regarding management's assertions pertaining to the uncertainties, and their presentation and disclosure, which may cause the auditor to conclude that it is not possible to form an opinion on the financial statements as a whole.

27. The IAASB did not agree with these two minority views. After full debate, the IAASB concluded that the need to disclaim an opinion arose more from the *combined effects* of the interaction of the various uncertainties on the financial statements as a whole. Consequently, the final guidance reflects this (see paragraph 12).

28. Given that a situation involving multiple uncertainties would likely be rare in practice, the IAASB decided not to give the issue undue prominence that would detract from the general principles pertaining to disclaimers of opinion in the ISA. Accordingly, it concluded that no requirement should be imposed in such a situation. Instead, the guidance states that the auditor is not precluded from disclaiming an opinion in such a situation (see paragraph 12).

29. A number of respondents suggested that the guidance should be strengthened to indicate that a disclaimer of opinion should only be issued in very rare and unusual circumstances, and only if the effect of the multiple uncertainties were material and pervasive. The IAASB did not agree that this would be necessary as the guidance was already set in the

[6] The IAASB reconsidered this decision during the redrafting of the close off document of ISA 705 (Revised) under the Clarity conventions and concluded that greater clarity would be achieved if those descriptions were to be elevated into definitions. See the Definitions section in the exposure draft of the proposed ISA 705 (Revised and Redrafted).

context of *extreme circumstances*. In addition, a disclaimer of opinion, by definition, should only be needed if the possible effect were not only material but also pervasive.

30. Some respondents were concerned that the guidance was unclear as to whether EOMs would still required for each uncertainty, in addition to the disclaimer of opinion. The IAASB did not believe that this point warranted further guidance as the Basis for Disclaimed Opinion paragraph would describe all the substantive reasons for the disclaimer, thus obviating the need for EOMs in the circumstances.

Disclosure of Omitted Information in the Auditor's Report

31. ED-ISA 705 proposed that if there is a disagreement with management about disclosures, the auditor should provide the omitted disclosures in the basis for modified opinion paragraph, unless impracticable or prohibited by law or regulation. Two respondents expressed strong support for the proposal, recognizing that the requirement would effectively put pressure on management to present the required disclosures.

32. Several other respondents, however, expressed significant concern. They argued that it would establish a precedent for the auditor to take on management's responsibility for preparing the financial statements, as this would, de facto, result from a requirement for the auditor to provide omitted financial information regardless of guidance in the proposed ISA cautioning the auditor against doing so. In addition, several of them were of the view that unless further guidance was provided to explain how the auditor would apply the test of practicability under the proposed requirement, practitioners would be unable to interpret and apply the requirement consistently.

33. The IAASB debated at length the advantages and disadvantages of requiring the auditor to disclose information that management had failed to disclose (unless impracticable or prohibited by law or regulation), and believed that it would be in the public interest for there to be such a requirement.

34. After further debate, the IAASB reaffirmed its view that the public interest was the overriding consideration and concluded that the auditor would not be assuming management's role if the information were readily available. Accordingly, the basic requirement has been retained, but refined to mandate that the auditor should first describe in the basis for modification paragraph the *nature* of the omitted information and then, unless prohibited by law or regulation, *include* the omitted disclosures, provided it is practicable to do so, and the auditor has obtained sufficient appropriate audit evidence about the omitted information (see paragraph 44).

35. To clarify the concept of practicability, the IAASB provided guidance on when it would *not* be practicable to provide the omitted disclosures, i.e.:

    (a) When the auditor would be assuming management's responsibility for the preparation of the omitted disclosures; or

    (b) When, in the auditor's judgment, the disclosures would be unduly voluminous in relation to the auditor's report. (See paragraph 45).

36. The IAASB further clarified that the auditor might be assuming management's responsibility for the preparation of the omitted disclosures if the omitted disclosures had not been prepared by management or were otherwise not readily available to the auditor (see paragraph 46).

Misleading Financial Statements Resulting from Applying the Financial Reporting Framework

37. Two respondents suggested a need for requirements and guidance in the proposed ISA 705 to address these circumstances so as to ensure completeness of the ISA and consistency with ISA 700. The IAASB considered the practicality of this suggestion but concluded that the drawbacks outweighed the potential benefits, as introducing specific requirements and guidance to deal with what would be extremely rare circumstances would over-complicate the ISA. The IAASB was of the view that the guidance included in ISA 700 appropriately left the modification of the report in those circumstances to the auditor's professional judgment.

Pre- and Post-Acceptance Scope Limitation Imposed by Management

38. ED-ISA 705 proposed requirements and guidance on the auditor's responsibilities when, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements.

39. A number of respondents argued that ISA 705 should also deal with a pre-acceptance scope limitation imposed by management. They were concerned that agreeing to a scope limitation before the audit has started would seriously threaten the auditor's independence and make it impossible for the auditor to meet the requirements of auditing and ethical standards. They therefore suggested that a requirement should be introduced to the effect that if the auditor were to become aware, before accepting the audit, that those charged with governance or management would impose a scope limitation that the auditor would consider likely to result in the need to qualify or disclaim an opinion, the auditor should not accept that engagement, unless required to do so by law or regulation.

40. The IAASB accepted this suggestion but only when such a management-imposed scope limitation would lead to a disclaimer of opinion. The IAASB was of the view that a blanket prohibition on engagement acceptance in all cases of pre-acceptance scope limitations would be impracticable and that the prohibition should only apply in the most serious cases that would require disclaimers of opinion. Given that ISA 705 addresses reporting considerations only and not matters relating to engagement acceptance or continuance, the IAASB concluded that this requirement should be included in ISA 210, "Terms of Audit Engagements," by way of a conforming amendment (see new paragraphs 26-27 in the conformed ISA 210).

41. Some respondents pointed out that although ED-ISA 705 proposed to allow the auditor to consider resigning from the audit if the auditor became aware of a management-imposed scope limitation and if permitted by law or regulation to do so, it did not address circumstances where resignation was not permitted by law or regulation (as might be the

case in certain public sector audits). The IAASB agreed that the only possible outcome in this case would be for the auditor to disclaim an opinion. Accordingly, guidance has been provided to that effect (see paragraph 33).

42. Two respondents suggested that the ISA should be strengthened by requiring the auditor to disclaim an opinion should management impose any scope limitation on the audit. The IAASB did not agree with this suggestion on the ground the auditor should be allowed the opportunity to consider the reasons for such a scope limitation, and whether alternative procedures would be appropriate and could be performed.

Piecemeal Opinions

43. ED-ISA 705 described a piecemeal opinion as comprising an adverse opinion or a disclaimer of opinion on the financial statements as a whole, and a supplementary unmodified opinion on one or more specific elements, accounts or line items of a financial statement. Guidance in ED-ISA 705 explained that such an opinion is not permitted because it would overshadow or contradict the adverse opinion or the disclaimer of opinion.

44. Many respondents noted that the prohibition to issue such a piecemeal opinion had all the characteristics of a basic principle, and therefore suggested that the guidance be elevated to a requirement. The IAASB accepted this suggestion (see paragraph 35).

45. Several of the respondents commented that the proposed guidance appeared to contradict the requirement in paragraph 11(c) of ISA 510, "Initial Engagements–Opening Balances," which permits, in the event that the auditor is unable to obtain sufficient audit evidence regarding opening balances, the auditor to issue an opinion which is qualified or disclaimed on the results of operations but "unqualified" on the closing financial position. Some of these respondents pointed out that such "piecemeal opinions" are permitted in some jurisdictions on the ground that positive assurance should be allowed on those parts of the financial statements unaffected by circumstances giving rise to an adverse or disclaimed opinion.

46. The IAASB did not agree that the guidance proposed in the exposure draft was inconsistent with the requirement in ISA 510 because the latter does not address a piecemeal opinion as defined in ED-ISA 705. The circumstances dealt with in paragraph 11(c) of ISA 510 do not include those where the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements as a whole. Thus, the precondition for a piecemeal opinion as described in ED-ISA 705 would not be in place in the ISA 510 situation. To emphasize the specific meaning attributed to the term "piecemeal opinion" in ISA 705, the IAASB agreed to add the phrase "For the purpose of this ISA" at the beginning of the guidance describing the nature of a piecemeal opinion (see paragraph 34).

47. Some respondents suggested that the guidance appeared inadequate in that it did not address situations such as other reporting responsibilities covered by paragraphs 46-49 of ISA 700 (as approved in December 2004) (i.e. legal or regulatory responsibilities to report on other matters). They questioned whether the auditor would, for example, be able to issue an unmodified opinion in respect of the proper preparation of the financial statements in accordance with the requirements of Country X Corporation Act if there were an adverse or disclaimed opinion in respect of whether the financial statements are

fairly presented in accordance with International Financial Reporting Standards (or vice versa). The IAASB, again, concluded that these circumstances would not fall within the description of a piecemeal opinion as set out in ED-ISA 705 because these other reporting responsibilities do not relate to the same financial reporting framework. The IAASB, however, agreed to make this clear in the wording of the prohibition (see paragraph 35).

Description of the Auditor's Responsibility in the Auditor's Report

48. ED-ISA 705 proposed that the description of the auditor's responsibility in the auditor's report should be appropriately amended when the auditor is unable to obtain sufficient appropriate audit evidence. It also provided illustrations of the wording changes that would be necessary to the auditor's responsibility section in those circumstances for the two cases when the auditor qualifies the opinion and when the auditor disclaims an opinion.

49. Three respondents disagreed with this proposal and suggested that the proposed amendments be repositioned to the end of the final paragraph of the Auditor's Responsibility section as follows:

- In the case of a qualified opinion:

  We believe that, with the exception of the matter described in the Basis for Qualification paragraph, the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

- In the case of a disclaimer of opinion:

  Because of the matter described in the Basis for Disclaimer of Opinion paragraph, we were not able to obtain sufficient appropriate audit evidence and therefore were not able to complete ~~an~~ our audit. ~~in accordance with International Standards on Auditing~~.

50. The IAASB accepted the respondents' suggestion regarding the case of a disclaimer of opinion, but with the following refinement since the audit would be effectively completed:

  Because of the matter described in the Basis for Disclaimer of Opinion paragraph, we were not able to obtain sufficient appropriate audit evidence ~~and therefore were not able to complete our audit~~ to provide a basis for an audit opinion.

51. In the case of a qualification, the IAASB concluded that no wording change should be made to the Auditor's Responsibility section because the audit evidence obtained by the auditor always provides a basis for the auditor's opinion, whether qualified or not. Accordingly, the IAASB concluded that there should be no requirement for the auditor to amend the Auditor's Responsibility section in the case of a qualification arising from an inability to obtain sufficient appropriate audit evidence. Instead, the wording of the last paragraph in the Auditor's Responsibility section should simply state:

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

Issues Specific to ISA 706 (Revised)

Criteria for Emphasis of Matter in the Auditor's Report

52. The IAASB proposed to establish a requirement in ED-ISA 706 for the auditor to emphasize in the auditor's report a matter in the financial statements when, in the auditor's judgment, both of the following conditions are met:

    (a) The matter is of fundamental importance to the user's understanding of the financial statements; and

    (b) The matter is unusual.

53. In proposing this requirement, the IAASB intended to minimize inconsistent practice by setting appropriate boundaries around which the auditor would determine when an EOM would be appropriate. The IAASB felt that in the absence of specific criteria that would circumscribe the use of EOMs, there would be a proliferation of EOMs that would undermine their effectiveness, potentially creating greater confusion amongst users. Accordingly, consistency was an important goal from an international standpoint.

54. This proposal, however, gave rise to significant concerns amongst respondents as well as representatives of the IAASB CAG. They argued that:

    - The proposed requirement would in fact cause a proliferation of EOMs because:
        - In highly regulated environments, there would be a greater tendency for auditors to use EOMs to minimize the risk of legal or regulatory action on the ground that they did not appropriately use EOMs when required in compliance with the ISAs; and
        - The proposed criteria did not seem sufficiently precise for consistent application as they could include a wide range of circumstances.
    - The proposal would cause unhelpful discussions between auditors and regulators on whether the appropriate judgment was exercised on matters that should already be fully disclosed in the financial statements.
    - The auditor should not be prohibited from communicating matters that the auditor believes should be brought to users' attention.
    - The proposed guidance on the first criterion did not sufficiently differentiate fundamental matters from significant matters that are not fundamental.

55. Some respondents argued that determining when to include an EOM in the auditor's report is a highly judgmental exercise that should be left to the discretion of the auditor. This view was shared by some representatives of the IAASB CAG who argued that the auditor should be permitted the flexibility to emphasize a matter if the auditor judges it appropriate to do so. These respondents suggested that the best course of action would be to establish no requirement for when matters should be emphasized in the auditor's report, but to issue guidance that would enable auditors to exercise professional judgment in deciding when to include EOMs, subject to strict limitations to prevent their misuse.

56. In light of these practical concerns, the IAASB concluded that an approach mandating the use of EOMs under specific limited circumstances would probably not achieve the desired benefits of consistency. The IAASB was, however, persuaded by the argument that the determination of whether to include an EOM in the auditor's report should ultimately be a matter for the auditor to decide given the inherently high level of judgment needed on such matters. The IAASB agreed that the determining criterion for the auditor should be that the matter is of *such importance that it is fundamental to the users' understanding of the financial statements*. The IAASB determined that any further explanation of the meaning of the term "fundamental" would be impracticable and unnecessary as this would be a matter for the auditor's judgment in the circumstances.[7]

57. Some respondents suggested that a further criterion should be specified to the effect that *sufficient appropriate audit evidence* should have been obtained about the matter being emphasized. They argued that this would help avoid the potential misuse of EOMs as a substitute for the modified opinions that would be appropriate if there were an inability to obtain sufficient appropriate audit evidence. The IAASB accepted this suggestion (see paragraph 7) as this would be consistent with the description of the nature of an EOM. To reinforce this message, the IAASB also agreed to include guidance to stress that an EOM is not a substitute for either:

- The auditor's expressing a qualified opinion or an adverse opinion, or disclaiming an opinion, when required by the circumstances of the engagement; or
- Disclosures in the financial statements that the applicable financial reporting framework requires management to make. (See paragraph 8).

58. Finally, to emphasize that EOMs would be used only in rare circumstances, the IAASB agreed that guidance should highlight that a widespread use of EOMs diminishes the effectiveness of the auditor's communication of such matters (see paragraph 6).

59. A few respondents opposed the use of EOMs in auditors' reports, except in the case of a material uncertainty relating to the going concern basis. They argued that:

- Financial statements should stand on their own merits and readers should read them in their entirety to obtain a full understanding of the entity's financial results, financial position and cash flows;
- The auditor should not have additional reporting responsibilities when the matters contemplated for the EOMs are already appropriately presented or disclosed in the financial statements;
- Financial reporting frameworks require many subjective assessments of material items to be made (e.g. impairments, pension valuations, valuations of financial instruments), all of which could be equally emphasized in EOMs; and

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[7] As a result of redrafting the close off document of ISA 706 (Revised) under the Clarity conventions, the IAASB reconsidered this approach and concluded that greater clarity would be achieved if a requirement were to be introduced in the proposed redrafted ISA (see the explanatory memorandum accompanying the proposed ISA 706 (Redrafted)).

- Application of the proposed criteria would be too subjective for consistent reporting by auditors in similar situations.

60. The IAASB was not persuaded by these arguments, especially the singling out of going concern uncertainties for EOMs given that the reasons advanced by the respondents for not using EOMs in circumstances other than a going concern uncertainty could equally apply to going concern uncertainties.

Significant Uncertainty vs. Material Uncertainty

61. ED-ISA 706 identified a "significant uncertainty" as an example of a matter that the auditor would include in an EOM if it were to be both unusual and of fundamental importance to the user's understanding of the financial statements. This terminology differed from a "material uncertainty" used in ISA 570, "Going Concern," in relation to the entity's ability to continue as a going concern and for which an EOM would be required under that ISA. The explanatory memorandum to ED-ISA 706 asked for respondents' views as to whether the co-existence of these two terms in the ISA literature would cause confusion.

62. Respondents generally agreed that there would be confusion if these two terms were to be retained without any further explanation of their meaning. Some noted that any intended differences between the two terms would likely be lost on translation. These views were shared by a number of representatives on the IAASB CAG.

63. In issuing ED-ISA 706, the IAASB took the view that the terms "significant" and "material" were equivalent when dealing with uncertainties (but not in relation to other matters). Given the comments received, the IAASB concluded that this distinction was too subtle and that it would be undesirable to have the two terms co-exist in the ISAs without a clear explanation of their intended meanings.

64. The IAASB CAG generally acknowledged that it would be difficult to define the two terms as separate concepts. Accordingly, some representatives suggested that, as an alternative, an EOM in the auditor's report could emphasize an uncertainty without using the term "significant." This approach was also advocated by a respondent to the exposure draft who argued that a way to reconcile the two terms was simply not to use the word "significant" when referring to uncertainties in the proposed ISA. This respondent noted that it would be in fact unnecessary to qualify the uncertainties referred to in ISA 706 as significant because if the auditor were to determine that they should be emphasized in the EOM, they would need to meet the criterion of "fundamental importance." The uncertainties would thus necessarily be significant.

65. The IAASB accepted this argument. Accordingly, it concluded that ISA 706 should simply refer to "uncertainties" as matters for emphasis under the appropriate circumstances (see paragraph 10).

66. Finally, the IAASB acknowledged that an entity may disclose an uncertainty that the auditor judges it necessary to emphasize in an EOM by using any one of a number of possible terminologies, including "material uncertainty," "significant uncertainty," "major uncertainty," and "fundamental uncertainty." The IAASB concluded that consistency of

terminology between the auditor's report and the financial statements in referring to the same matter should be the overriding consideration, regardless of how an uncertainty is technically described in ISA 706. Accordingly, the IAASB added a footnote to the illustrative report in the close off document of ISA 706 (Revised) to the effect that in emphasizing an uncertainty, the auditor should use the same terminology that management has used to describe the uncertainty in the financial statements.

Other Matters Paragraph

67. ED-ISA 706 proposed that the auditor should deal with other matters that the auditor considered it necessary to communicate in the auditor's report in a separate paragraph of the report using an "Other Matters" heading to indicate that the paragraph deals with an "other matter."

68. Several respondents expressed concern that the guidance on "other matters" was too broad and appeared to expand the auditor's report beyond financial reporting matters or matters directly related to the audit. In particular, they argued that:

    - The proposal did not clearly articulate the purpose and boundaries of other matters paragraphs.
    - The guidance permitting the auditor, in rare and unusual circumstances, to communicate other matters considered relevant implied that the auditor might report on any other matter, even those beyond the auditor's objectives.
    - The proposal introduced the undefined concept of "relevant to communicate to the user."

69. In proposing the requirement that the auditor use an Other Matter(s) paragraph to deal with an other matter, the IAASB intended to provide the auditor with the flexibility to communicate other matters that would not be appropriate to emphasize in EOMs. The proposed requirement purposefully dealt with matters that are not required to be presented or disclosed in the financial statements under the applicable financial reporting framework, and allowed the auditor the benefit of exercising professional judgment to determine when such other matters should be communicated in the auditor's report. The IAASB reaffirmed its view that the requirement and guidance on other matters remained appropriate.

70. Two respondents questioned whether anyone other than an experienced auditor would be able to understand the difference between an EOM and an "other matter." They noted that the guidance on all the matters described in ED-ISA 706 was intended to achieve the same objective, i.e. to emphasize a matter in the financial statements or a matter related to the audit of such financial statements. Accordingly, they argued that it would be confusing to label these matters differently. The IAASB did not agree with these views as the distinction between an EOM and an "other matter" is pertinent – that is, an EOM is intended only for matters that are already presented or disclosed in the financial statements whereas an Other Matter(s) paragraph is intended to deal with matters *other than* those presented or disclosed in the financial statements. The IAASB agreed to make this contrast clear in the ISA (see paragraphs 14-15).

71. One respondent indicated that there was insufficient guidance to differentiate between an Other Matter(s) paragraph and a paragraph dealing with matters on which the auditor is specifically required to report by law or regulation (which would fall within the second part of the auditor's report as dealt with under paragraph 43 of the amended ISA 700). The IAASB agreed to clarify the inter-relationship between the guidance in paragraph 43 of the amended ISA 700 and the "other matters" in ISA 706 by indicating that the matters addressed under the former are included within the scope of the latter (see paragraph 17(c)).

72. However, ISA 706 does not 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. The IAASB also agreed to make this distinction clear by adding guidance to the effect that an Other Matter(s) paragraph does not 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, or where the auditor has been asked to perform and report on additional specified procedures, or to express an opinion on specific matters (see paragraph 18).

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