

IAASB CAG PAPER



International Federation of Accountants

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Agenda Item

B-3

Committee: IAASB Consultative Advisory Group

Meeting Location: Toronto

Meeting Date: September 11-12, 2006

Report Back—Modifications

Objective of Agenda Item

To report back on the Representatives' May 11-12, 2006 comments on 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," further to the July 2006 IAASB meeting.

May 11-12, 2006 CAG Representatives' Comments

The table below provides relevant extracts from the minutes of the May 11-12, 2006 CAG meeting¹ and an indication of how the IAASB task force or the IAASB responded to the Representatives' comments in finalizing the "close off" versions of the proposed ISAs 705 and 706 under the old drafting conventions.

Representatives' comments	IAASB task force/IAASB response
Proposed ISA 705	
Mr. Rabine and Ms. Sucher supported the task force's proposed approach to explaining the meaning of pervasiveness in relation to the effects of misstatements. Ms. Sucher asked that it is clarified that the decision about pervasiveness is made in the context of the auditor's professional judgment.	The task force notes that the role of professional judgment has been reflected in two places – firstly, in the heading in the table that provides an overview of the different types of modified opinions, and secondly, in the first line of the paragraph that describes pervasive misstatements ("The auditor may judge ..."). Refer to paragraphs 8 & 9 of proposed ISA 705 in Appendix 1.
In relation to multiple uncertainties leading to a disclaimer of opinion, Mr. Van Der Plaats was of the view that the paragraph did not provide sufficient guidance on what the auditor should consider before coming to the conclusion that it is not possible to form an opinion on the financial statements as a	The majority of the IAASB is of the view that the decision as to whether to disclaim an opinion in such a situation should be left to the auditor's judgment <i>in the circumstances</i> . A requirement would not be appropriate in this case as not all situations involving multiple uncertainties would necessarily lead to

¹ The minutes will be approved at the September 11-12, 2006 IAASB CAG meeting.

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<p>whole due to the cumulative possible effects of the uncertainties. Mr. Uchino, on the other hand, was concerned that the lack of a requirement, as well as leaving it to the auditor's professional judgment, may lead to the auditor not disclaiming an opinion where it is appropriate.</p>	<p>disclaimers of opinion. The principal consideration is that, in some <i>extremely rare circumstances</i>, because of the interaction and cumulative possible effects of the multiple uncertainties, the auditor may reach a point at which it no longer becomes possible to form an opinion on the financial statements.</p>
<p>Ms. Koski-Grafer noted that in following an approach that links the disclaimer of opinion to the cumulative possible effects of the multiple uncertainties, it is necessary to clarify that the existence of multiple uncertainties would not automatically lead to a disclaimer of opinion.</p>	<p>The task force's view is that the absence of a requirement to disclaim an opinion in a situation of multiple uncertainties effectively means that multiple uncertainties do not automatically lead to a disclaimer of opinion. In addition, the IAASB agreed to change the last sentence in the paragraph to state that the auditor is not precluded from disclaiming an opinion in such a situation. This would clearly imply that the auditor is not required to disclaim an opinion when multiple uncertainties exist. Refer to paragraph 12 of proposed ISA 705 in Appendix 1.</p>
<p>In relation to disclosure of omitted information in the auditor's report, Mr. Popham was of the view that it should be clarified that the auditor normally would only describe the nature of omitted information; however, if management has made representations about such information, it may be possible to quantify it.</p>	<p>The task force notes that proposed ISA 705 requires the auditor to disclose the nature of the omitted information in such a situation, so this would always be done. In addition, the proposed ISA requires the auditor to disclose the omitted information provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about it. The auditor would not obtain sufficient appropriate audit evidence if management has not provided the auditor with the necessary representations regarding the information. Accordingly, the task force believes appropriate boundaries have been placed around this requirement. Refer to paragraph 44 of proposed ISA 705 in Appendix 1.</p>
<p>Proposed ISA 706</p>	
<p>In relation to the approach for emphasis of matter paragraphs, Ms. Koski-Grafer and Mr. Rabine were concerned that the auditor will not be allowed to draw attention to an uncertainty that is in the ordinary course of business. Mr. Rabine noted that uncertainties relating to impairment tests are in the</p>	<p>The IAASB concluded that the only appropriate criterion should be that the matter is of such importance that it is fundamental to the users' understanding of the financial statements. Such occurrences would still be rare but there is no limitation on these matters being outside the ordinary</p>

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ordinary course of business, but are matters that may need to be emphasized.	course of business. <i>Refer to paragraph 7 of proposed ISA 706 in Appendix 2.</i>
Ms. Sucher was of the view that the proposed ISA should contain more examples of auditors' reports that include emphasis of matter paragraphs.	The task force believes that it is unnecessary to provide several example reports as the principles and guidance in the proposed ISA are relatively simple.
Ms. Sucher also noted that the last sentence of paragraph 12 of proposed ISA 706 should be made much stronger by clearly explaining that, in the case of an auditor's report that includes a modified opinion and an emphasis of matter paragraph, there should be no relationship between the modification and the matter being emphasized.	The task force notes that the proposed ISA effectively makes this point clear by stating that an emphasis of matter is not a substitute for the auditor expressing a qualified opinion or an adverse opinion, or disclaiming an opinion, when required by the circumstances of the audit engagement. <i>Refer to paragraph 8 of proposed ISA 706 in Appendix 2.</i>
In relation to the inclusion of other matters in the auditor's report, Mr. Sekiguchi asked whether other matters that are not required to be recognized or disclosed in the financial statements by the applicable financial reporting framework include a description of the auditor's independence as required by law or regulation in some jurisdictions. He was of the view that it might be useful for the IAASB to consider including a reference to the auditor's independence in an other matter paragraph, since some countries require such a reference in the auditor's report.	The task force's view is that this situation would be covered under paragraph 17(c) of the close-off version of the proposed ISA, i.e. "where standards or laws require, or generally accepted practice in a jurisdiction permits the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in an audit of financial statements or of the auditor's report thereon." The task force, however, believes that the nature of the matters that can fall under this category can vary from jurisdiction to jurisdiction and, accordingly, it would not be appropriate to highlight a specific type of matter in these circumstances. <i>Refer to paragraph 17 of proposed ISA 706 in Appendix 2.</i>

The July 2006 IAASB meeting material for Modifications is available from
<http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0066&ViewCat=0549>

Appendix 1

Relevant Extracts from Proposed ISA 705 (Closed-off Version)

Determining the Type of Modification to the Auditor's Opinion

[...]

8. The table below illustrates how the auditor's judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

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

Pervasiveness of the Matter or Matters Giving Rise to a Modification

Financial Statements are Materially Misstated

9. The auditor may judge misstatements that are material individually or in the aggregate to be pervasive to the financial statements when such misstatements are not confined to specific elements, accounts or items in the financial statements or, if confined, the misstatements represent or could represent a substantial proportion of the financial statements.

[...]

Multiple Uncertainties

12. In cases involving multiple uncertainties, the auditor may conclude in extremely rare circumstances that it is not possible to form an opinion on the financial statements as a whole due to the interaction and 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. The auditor is not precluded from disclaiming an opinion in such a situation.

[...]

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

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Basis for Modification Paragraph

[...]

44. **If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor should describe in the Basis for Modification paragraph the nature of the omitted information and, 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.**

Appendix 2

Relevant Extracts from Proposed ISA 706 (Closed-off Version)

Emphasis of a Matter in the Financial Statements in the Auditor's Report

[...]

7. The auditor may determine it is appropriate to emphasize in the auditor's report a matter presented and disclosed in the financial statements when, in the auditor's judgment, the matter is of such importance that it is fundamental to the users' understanding of the financial statements, provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements.
8. The inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion. An emphasis of matter is not a substitute for either (a) the auditor expressing a qualified opinion or an adverse opinion, or disclaiming an opinion, when required by the circumstances of a specific audit engagement (see [proposed] ISA 705), or (b) disclosures in the financial statements that the applicable financial reporting framework requires management to make.

[...]

Other Matter(s) in the Auditor's Report

[...]

17. Examples of other matters that are not required to be recognized or disclosed in the financial statements by the applicable financial reporting framework include the following:
 - (a) Avoidance of auditor association with materially inconsistent information in a document containing audited financial statements (see ISA 720, "Other Information in Documents Containing Audited Financial Statements").
 - (b) Circumstances where the incoming auditor is permitted to refer to the predecessor auditor's report on the corresponding figures in the incoming auditor's report for the current period (see ISA 710, "Comparatives").
 - (c) Where standards or laws require, or generally accepted practice in a jurisdiction permits, the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in an audit of financial statements or of the auditor's report thereon.
 - (d) In rare circumstances, other matters that the auditor considers necessary to communicate to the user, for example, where the auditor judges it necessary to explain why the auditor is unable to resign from the engagement even though the

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possible effect of an inability to obtain sufficient appropriate audit evidence due to a scope limitation imposed by management is pervasive.