

## IAASB CAG PAPER

IAASB CAG Agenda (March 2008)

Agenda Item C.3.3.2

Clarity – Proposed ISA 705 (Revised and Redrafted) and Proposed ISA 706 (Revised and Redrafted)

### **Matters for CAG Consideration—Proposed ISA 705 (Revised and Redrafted), “Modifications to the Opinion in the Independent Auditor’s Report” and Proposed ISA 706 (Revised and Redrafted), “Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor’s Report”**

#### **PROPOSED ISA 705 (REVISED AND REDRAFTED), “MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR’S REPORT”**

1. Forty-six comment letters were received. On balance, respondents were in agreement with the application of the clarity conventions. The following paragraphs summarize the comments received on the exposure draft. Matters for consideration by CAG Representatives relate to the definition of the term “pervasive” (as discussed in paragraphs 4-7). In addition, CAG Representatives may wish to familiarize themselves with comments that go beyond the clarity drafting conventions (as discussed in paragraphs 10-20); however, a detailed consideration of these is not necessary.

#### **Objective**

2. The proposed ISA contained the following objective:

*“The objective of the auditor is to express clearly an appropriate modified opinion on the financial statements that is necessary:*

- (a) When the auditor concludes that the financial statements are not free from material misstatement; or*
- (b) When the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the final statements are free from material misstatement.”*

3. The majority of respondents supported the objective. One respondent noted their final position on the appropriateness of the objective would depend on the outcome of the ongoing revision to proposed ISA 200 (Revised and Redrafted). One respondent suggested that the objective be reworded to be more outcome oriented, but did not offer alternative wording.

#### **Definition**

4. The proposed ISA includes the following definition of the term “pervasive:” *“in the context of misstatements or an inability to obtain sufficient appropriate audit evidence, the term pervasive is used to describe the effects or possible effects on the financial statements of a matter that, in the auditor’s judgment, are not confined to specific elements, accounts or items of the financial statements, or, if confined, represent or could represent a substantial proportion of the financial statements.”*
5. The majority of respondents supported inclusion of a definition in the ISA. Respondents commented that a definition enhances the clarity of the ISA and that it is fundamental to understanding the ISA.

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6. While a number of respondents supported the proposed definition, others found the definition complex and internally contradictory. A few respondents also commented that the application material supporting the discussion of adverse and disclaimer of opinions seemed to repeat the definition of pervasive as opposed to enhancing it.

7. As far as suggested improvements of the definition:

- A number of respondents suggested breaking the definition down into sentences or bullets.
- A few respondents suggested it would be useful if the definition incorporated the phrase “fundamental to users’ understanding” included in paragraph 10 of the close-off document. Accordingly, one respondent suggested the following revised definition:

*...the term pervasive is used to describe the effects or possible effects on the financial statements of a matter that, in the auditor’s judgment either:*

*(a) are not confined to specific elements, accounts or items of the financial statements; or*

*(b) if so confined, represent ~~or could represent~~ a substantial proportion of the financial statements or is fundamental to users’ understanding of the financial statements.*

- One respondent suggested that the definition clearly state that, when used in the context of a modified opinion, the term “pervasive” would apply to a misstatement, an aggregation of misstatements, or an inability to obtain sufficient appropriate audit evidence that a) could cause the financial statements taken as a whole to be misleading, or b) is so widespread that the auditor cannot determine if the financial statements taken as a whole are fairly presented. This respondent recommended that the definition be expanded as follows:

*~~... in the context of misstatements or an inability to obtain sufficient appropriate audit evidence,~~the term pervasive is used to describe the effects or possible effects on the financial statements of a misstatement, or aggregation of misstatements, or an inability to obtain sufficient appropriate audit evidence ~~matter that, in the auditor’s judgment, are not confined to specific elements, accounts or items of the financial statements, or, if confined, represent or could represent a substantial proportion of the financial statements:~~*

*(a) cause the financial statements taken as a whole to be misleading, or*

*(b) are so widespread that the auditors cannot determine if the financial statements taken as a whole are fairly presented.*

#### Requirements

8. The majority of respondents were of the view that the criteria identified by the IAASB for determining whether a requirement should be specified have been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and reporting, and the use of professional judgment by auditors.

9. Although some respondents commented on the appropriateness of some of the requirements or suggested refinement, no single requirement received a significant number of comments.

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#### Significant Comments that Do Not Relate to the Application of the Clarity Conventions

10. Representatives may recall that extant ISA 701<sup>1</sup> was subject to full revision in a project that led to the finalization of a close off document. (A close off document is a final version of a standard whose revision had commenced before the clarity drafting conventions had been finalized. Absent the Clarity project, a final standard would have been issued rather than a close off document and the project would have ended at that time. It was the IAASB's intention that any close off document should be converted to a clarified version without further consideration of substantive issues.) Inevitably, as elements of ISA 705 (Revised) were quite controversial, some respondents took the opportunity to seek to reopen aspects of the close off document with which they disagreed. These are summarized below.

#### *The Auditor's Actions in the Case of a Management-imposed Scope Limitation*

11. A few respondents did not agree with paragraph 15 which essentially enables the auditor to resign from the audit, when practicable and possible, without issuing a report if the possible effects of a management-imposed scope limitation imposed by management are both material and pervasive to the financial statements and the auditor is unable to obtain the necessary evidence by performing alternative procedures.
12. One respondent in particular was of the view that resignation without issuing a report is not consistent with the objective of the ISA since it requires the auditor to express an appropriate modified opinion when the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements are free of material misstatement. The requirement in the ISA for communication of the scope limitation to those charged with governance before resigning is not enough. The respondent, supported by another, believed it is important that the auditor communicate to those charged with governance the intention to disclaim an opinion and, where the management-imposed limitation still remains, to issue a report that includes:
- a disclaimer of opinion; and
  - a basis of modification paragraph that describes, as required by proposed paragraph 23, the reasons (and effects thereof) for any other matters that would have required a modification to the opinion (even if the auditor has disclaimed an opinion)

#### *Multiple Uncertainties Leading to a Disclaimer*

13. A few respondents commented that the guidance included regarding multiple uncertainties was not aligned with the requirements and suggested that this be addressed. This guidance, included as paragraph A14 of the proposed ISA, indicates: "*In cases involving multiple uncertainties, the auditor may conclude in extremely rare circumstances that it is not possible to form an opinion*

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<sup>1</sup> Extant ISA 701, "Modifications to the Independent Auditor's Report" was revised to enhance the standards and guidance on modifications to the auditor's opinion and Emphasis of Matter paragraphs. In revising and redrafting the standard, it was divided into two standards, i.e., ISA 705 (Revised) and ISA 706 (Revised).

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*on the financial statements as a whole due to the interaction and cumulative possible effects of 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.*" Some supported the inclusion of this guidance, but believed that the proposed ISA needed to clarify how a disclaimer of opinion for multiple uncertainties fits within the framework of proposed ISA 705 (Revised and Redrafted) since the ISA requires a disclaimer of opinion to be expressed when the auditor has been unable to obtain sufficient appropriate audit evidence and this inability relates to matters which are both material and pervasive.

14. One respondent suggested that a disclaimer in the case of multiple uncertainties relates more to the requirement in proposed ISA 700 (Redrafted) for the auditor to standback and consider the view given by the financial statements as a whole.
15. Another respondent proposed that the requirement in paragraph 12 be expanded as follows to specifically recognize multiple uncertainties as another circumstance when a disclaimer of opinion can be expressed [proposed additional text is underlined]:

*"The auditor shall disclaim an opinion on the financial statements when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the audit opinion, and the possible effects on the financial statements of that inability are both material and pervasive or when the auditor concludes 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 multiple uncertainties, even though the auditor has obtained sufficient appropriate audit evidence about management's assertions regarding each of the individual uncertainties."*

16. Paragraph 28 of the Basis for Conclusions: Close Off Documents—ISA 705 (Revised) and ISA 706 (Revised) explains that 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, the IAASB concluded that no new requirement should be imposed in such a situation and included the guidance in paragraph A14.

#### *Disclosure of Omitted Information in the Auditor's Report*

17. A few respondents commented that parts of the requirement in paragraph 21 are inappropriate. The requirement states:

*"If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall 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."*

18. These respondents were of the view that, as the preparation of the financial statements is the responsibility of management and those charged with governance, it is inappropriate for the

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auditor to take on management's role and use the auditor's report as a vehicle for disclosures that should otherwise be in the financial statements. One respondent believed that the application and other explanatory material, which highlighted that this would be impracticable if the auditor would be assuming management's responsibility for the preparation of the omitted disclosures, was contradictory to the requirement. Others suggested this matter should be discussed with those charged with governance.

19. One respondent, who had not responded to previous exposure drafts on ISA 705 (Revised), was concerned that disclosures by the auditor could potentially confuse investors and the public as to the respective responsibilities of management and auditors, may violate confidentiality principles and rules, and harm the legitimate interests of the audited entity. In support of this view the respondent cited the fact that the European Directive on market abuse enables an issuer to *"under his own responsibility delay the public disclosure of inside information, such as not to prejudice his legitimate interests provided that such omission would not be likely to mislead the public and provided that the issuer is able to ensure the confidentiality of that information."*
20. Paragraphs 33 and 34 of the Basis for Conclusions: Close Off Documents—ISA 705 (Revised) and ISA 706 (Revised) explains that after lengthy debate, the IAASB believed that it would be in the public interest for this requirement to be included in the ISA. The IAASB also concluded that the auditor would not be assuming management's role if the information were readily available. The IAASB believed the additional application and other explanatory material that was added in the close-off document clarified the concept of practicability and adequately addressed concerns that the auditor would be seen to be assuming management's responsibilities.

<b>Matter for Consideration by the IAASB CAG:</b>
Q1 Do Representatives have any views with regard to the comments relating to the proposed definition of the term pervasive?
Q2 In principle, the IAASB is entitled to ignore comments that go beyond the clarity drafting conventions, since these had all been considered in the process of finalizing the close off document of ISA 705 (Revised). Do Representatives have any views on the subject matter of those comments that might suggest a different approach?
Q3 Are there any other comments that Representatives may wish to raise?

#### *Exposure Draft of Proposed ISA 705 (Revised and Redrafted) Material Presented – IAASB CAG REFERENCE PAPERS*

Available at  
<http://www.ifac.org/Guidance/EXD-Details.php?EDID=0091>

Exposure Draft of Proposed ISA 705 (Revised and Redrafted)

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#### **PROPOSED ISA 706 (REVISED AND REDRAFTED), “EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER(S) PARAGRAPHS IN THE INDEPENDENT AUDITOR’S REPORT”**

21. Forty-five comment letters were received. On balance, respondents were in agreement with the application of the clarity conventions.

#### **Objective**

22. The proposed ISA contained the following objective:

*“The objective of the auditor is to include clear additional communication in the auditor’s report when, in the auditor’s judgment, such communication is appropriate to draw users’ attention to a matter presented or disclosed in the financial statements or to any other matter which may be relevant to their understanding of the financial statements or the audit.”*

23. Half of the respondents supported the objective as drafted in the proposed ISA. A few respondents, while supporting the objective, believed it was important to include reference to the fact that the inclusion of an Emphasis of Matter (EOM) paragraph or an Other Matter(s) paragraph does not affect the auditor’s opinion.
24. Many who did not support the objective believed that the word “appropriate” should be replaced with “necessary.” Others believed the concept of communicating other matters that are “fundamental to users’ understanding” should be incorporated into the objective. A few felt the objective should include the notion that in some circumstances the auditor is required to include an EOM paragraph. A few recommended “information” be used rather than “communication,” as the auditor’s report as a whole constitutes a means of communication.

#### **Requirements**

25. The majority of respondents were of the view that the criteria identified by the IAASB for determining whether a requirement should be specified have been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and reporting, and the use of professional judgment by auditors.
26. Although some respondents commented on the appropriateness of some of the requirements or suggested refinement, with the exception in the requirement discussed below, no single requirement received a significant number of comments.
27. While respondents generally supported the proposal to include a requirement that provides for the auditor to use an EOM paragraph to draw users’ attention to information presented or disclosed in the financial statements (paragraph 7 of the exposure draft), one believed that this requirement did not set precise boundaries around the use of EOM paragraphs and may impose an additional reporting responsibility on the auditor that exceeds the objective of expressing an opinion on the financial statements. Some also believed that the requirement should note that in certain specified circumstances the auditor is *required* to include an EOM, and requested that the requirement distinguish this (this is also the case for Other Matter(s) paragraphs).

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<b>Matters for Consideration by the IAASB CAG:</b>
Q1 Do Representatives have any views with regard to the comments relating to the proposed objective or the requirement for the auditor to include an Emphasis of Matter paragraph?
Q2 Are there any other comments that Representatives may wish to raise?

*Exposure Draft of Proposed ISA 706 (Revised and Redrafted) Material Presented – IAASB*  
**CAG REFERENCE PAPERS**

Available at  
<http://www.ifac.org/Guidance/EXD-Details.php?EDID=0092>

Exposure Draft of Proposed ISA 706 (Revised and Redrafted)