October 2008

Basis for Conclusions: ISA 705 (Revised and Redrafted), Modifications to the Opinion in the Independent Auditor's Report

Prepared by the Staff of the International Auditing and Assurance Standards Board

International Federation of Accountants

BASIS FOR CONCLUSIONS:

ISA 705 (REVISED AND REDRAFTED), MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT

This Basis for Conclusions has been prepared by staff of the International Auditing and Assurance Standards Board (IAASB). It relates to, but does not form part of, ISA 705 (Revised and Redrafted), "Modifications to the Opinion in the Independent Auditor's Report," which was approved by the IAASB in June 2008.[1]

Background

1. In March 2005, the IAASB issued an exposure draft of proposed ISA 705 (Revised). The comment period for the proposed ISA closed on July 31, 2005. The IAASB gave due consideration to the comments received and approved the "close off" document of ISA 705 (Revised) in the "old style" (i.e., following the extant drafting conventions for ISAs) in July 2006.[2] The IAASB's Clarity conventions were applied to that document. An exposure draft of proposed ISA 705 (Revised and Redrafted) (ED-ISA 705) was published in July 2007.

2. The Clarity conventions used by the IAASB in redrafting its ISAs, and the authority and obligation attaching to those conventions, are established in ISA 200 (Revised and Redrafted), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing."[3]

3. The comment date for the exposure draft was November 30, 2007. The IAASB received forty-seven comment letters from a variety of respondents, including IFAC member bodies, national standard setters, firms, regulators, government organizations, and others. Comments were also discussed with the IAASB Consultative Advisory Group (CAG). The IAASB revised the proposed ISA as a result of these comments. The following summarizes the more significant issues raised by respondents, and how the IAASB addressed them.

Definition of Pervasive

4. The explanatory memorandum that accompanied ED-ISA 705 requested respondents to comment on the inclusion of the definition of the term "pervasive."

5. ED-ISA 705 included the following definition of 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

---

1 See minutes of the June 16-20, 2008 IAASB meeting at http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=4272.

2 The Basis for Conclusions: ISA 705 (Revised) and ISA 706 (Revised) and related close off documents are available on the IAASB website at http://www.ifac.org/Guidance/EXD-Details.php?EDID=0062.

3 ISA 200 (Revised and Redrafted), which was approved by the IAASB in June 2008 for submission to the Public Interest Oversight Board for its confirmation of due process, contains the final statement of the authority and obligation attaching to the Clarity conventions.

> 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.

6. Twenty-six respondents specifically commented on the definition. 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 the ISA.

7. While a number of respondents supported the proposed definition, a few found the definition complex and internally contradictory since it defined pervasive misstatements as those that are not confined to specific elements, accounts or items but then also acknowledged that pervasive misstatements may be confined to such specific elements, accounts or items. Some respondents also commented that the application material supporting the discussion of adverse opinions and disclaimers of opinion was not helpful since it merely repeated the definition of pervasive as opposed to enhancing it. One respondent thought that the drafting of the definition was not consistent with other definitions in the ISAs and it was not clear how this definition would be incorporated into the "Glossary of Terms."[4] Two respondents were of the view that the concept of materiality should be embedded into the definition of pervasive. A few suggested improvements to the definition.

8. After considering comments received, the IAASB decided to revise the definition to address the contradiction and the effects of disclosures in terms of those that are fundamental to users' understanding of the financial statements. Additionally, the IAASB accepted the suggestion that the definition could be broken down into bullets.

9. Given the changes to the definition described in paragraph 8, the IAASB concluded that it was not necessary for the definition to refer to the possibility that the financial statements may be misleading as suggested by a few respondents. The IAASB also did not support the view that the concept of materiality needed to be incorporated into the definition of pervasive; in developing the requirements in ED-ISA 705, the IAASB had previously considered whether the word "material" should be subsumed into "pervasive;" however, the IAASB agreed that in practice the phrase "material and pervasive" was frequently used and well understood.

10. The IAASB also agreed with those respondents who pointed out that the material contained in paragraphs A11-A13 of ED-ISA 705 duplicated the definition and, therefore, deleted these paragraphs.

Objective

11. ED-ISA 705 contained the following objective:

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

[4] It should be noted that the Glossary of Terms will be updated to reflect all definitions included in final ISAs.

(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.

12. The majority of respondents supported the objective. One respondent noted that their final position on the appropriateness of the objective would depend on the outcome of the ongoing revision of ISA 200 (Revised and Redrafted).[5] One respondent suggested that the objective be reworded to be more outcome-oriented, but did not offer alternative wording.

13. One respondent was of the view that the objective should clarify that the auditor's conclusion that the financial statements are not free from material misstatement is based on the audit evidence obtained. The IAASB concurred with this view, noting that this concept was highlighted in paragraph 9 of ED-ISA 705 and, as a result, the phrase "based on the audit evidence obtained" was included in the revised objective. The phrase "as a whole" was also added to the objective to align it with the concepts in proposed 700 (Redrafted).[6] This emphasizes that the materiality of a misstatement is to be judged in the context of the financial statements as a whole. Given the overwhelming support for the objective, the IAASB concluded that no other changes to the objective were necessary.

Requirements

14. 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.

15. Although some respondents commented on the appropriateness of some of the requirements or suggested refinement, no single requirement received a significant number of comments. Comments that resulted in changes to ED-ISA 705 as a result of the IAASB's deliberations are discussed below.

Determining the Type of Modification to the Auditor's Opinion

16. To more clearly differentiate modifications of the opinion involving misstatements as opposed to those involving the inability to obtain audit evidence, the requirements in paragraphs 8 and 9 of the final ISA were expanded to clarify that the auditor would qualify the opinion or issue an adverse opinion after having obtained sufficient appropriate audit evidence. This is consistent with the change made to the objective referred to in paragraph 13 above, in response to comments.

---

5 ISA 200 (Revised and Redrafted), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with ISAs.

6 Proposed ISA 700 (Redrafted), "Forming an Opinion and Reporting on Financial Statements."

17. One respondent did not believe it was appropriate to classify a disclaimer of opinion as a type of opinion, since by definition the auditor is unable to provide an opinion in the case of a scope limitation that warrants a disclaimer of opinion. This respondent was of the view that the standard would be clearer and translation into other languages would be facilitated if, instead of referring to modifications to the auditor's opinion, the ISA referred to modifications to the auditor's report. The IAASB noted that the close off document characterized a disclaimer of opinion as a type of modified opinion (this is also the case in extant ISA 701[7]). Further, the IAASB noted that referring to matters involving a qualified, adverse or disclaimer of opinion as matters that result in a modification to the auditor's report is not specific enough since such modifications also encompass modifications that do not affect the auditor's opinion such as Emphasis of Matter or Other Matter paragraphs.

18. Two respondents believed that ED-ISA 705 inappropriately describes an inability to obtain sufficient appropriate audit evidence as having "possible effects on the financial statements." These respondents stressed that an inability to obtain sufficient appropriate audit evidence does not, by itself, have any effect on the financial statements; rather, it affects the auditor's ability to conclude whether the financial statements are materially misstated. The respondent proposed that changes be incorporated throughout the ISA to replace the reference to possible effects of the scope limitation on the financial statements with possible effects of undetected misstatements on the financial statements.

19. The IAASB supported this view, and made changes along the lines suggested above as necessary throughout the final ISA.

Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence Due to a Management-Imposed Limitation after the Auditor Has Accepted the Engagement

20. Three respondents questioned whether it was necessary to mandate the order of the actions that the auditor follows in paragraphs 13-15 of ED-ISA 705 (paragraphs 11-13 of the final ISA) in the event that management imposes a limitation of the scope of the audit. In particular, they questioned whether it was necessary in all circumstances for the auditor to communicate the matter to those charged with governance before determining whether it is possible to perform alternative procedures. The respondent suggested restructuring paragraphs 13-15 to provide direction without mandating a specific order.

21. In addressing this point, the IAASB noted that the bold-lettered requirement in the close-off document provided more flexibility since it required the auditor to request removal of the scope limitation, and, if management refused, to communicate with those charged with governance and to determine whether it is possible to perform alternative procedures. In the light of the comments, the IAASB agreed to revert to the wording in the close-off document.

[7] 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).

22. Two respondents expressed concern about paragraph 16 of ED-ISA 705 (paragraph 14 of the final ISA) requiring an auditor, who determines it is necessary to resign from an engagement due to a management imposed scope limitation, to communicate to those charged with governance any matters of which the auditor has become aware that would have given rise to a modification of the opinion. They suggested that, while the auditor may have become aware of such matters before resigning, the auditor may not necessarily have been able to obtain sufficient appropriate audit evidence to allow the auditor to determine whether such matters would actually have given rise to a modification of the auditor's opinion. Accordingly, they were of the view that it would be appropriate to require the communication of such matters only if the auditor has obtained sufficient appropriate audit evidence prior to resignation.

23. The IAASB, while accepting the point that it would be necessary for the auditor to have obtained audit evidence to make this assessment, was concerned that limiting the auditor's disclosure in this way may lead to the avoidance of disclosure to those charged with governance when in fact such disclosure may be of value to them. To elaborate, if the ISA specifically spelled out the requirement for the auditor to have obtained sufficient appropriate audit evidence, it could be that some auditors would then be restricted in disclosing matters for which they had some evidence, but not sufficient appropriate audit evidence. The IAASB believed this flexibility was in the public interest and, as a result, no change was made to the requirement.

Prohibition on Issuing a Piecemeal Opinion

24. A number of respondents found the concept of "piecemeal opinion" confusing, despite the explanation in paragraph A18 of ED-ISA 705. Some were concerned that what was prohibited by the ISA was in fact common practice in their particular jurisdictions, and another was concerned that what was permitted, as outlined in the first bullet of paragraph A20 of ED-ISA 705, is not permitted in its jurisdictions. Others were unsure of the interaction between piecemeal opinions, split opinion as explained in ISA 510 (Redrafted),[8] and what is permitted under proposed ISA 805 (Revised and Redrafted).[9]

25. In evaluating the respondents' concerns, the IAASB concluded that use of the term "piecemeal opinions" was driving some of the confusion, and that further clarification within both the Requirements and the Application and Other Explanatory Material could help to alleviate these concerns. The IAASB agreed to modify the requirement to highlight that what is prohibited is a combination of an adverse opinion or a disclaimer of opinion on the financial statements ***as a whole*** and an unmodified opinion on a single financial statement or on one or more specific elements ***in the same report*** and with respect to the same applicable financial reporting framework. Essential explanatory material was added to the requirement to state that including an unmodified opinion in the same report would be contradictory. Accordingly, a reference to proposed ISA 805

8 ISA 510 (Redrafted), "Initial Audit Engagements—Opening Balances."

9 Proposed ISA 805 (Revised and Redrafted), "Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement."

(Revised and Redrafted) was also included to highlight that there were circumstances in which an auditor would be permitted to express a separate opinion on one or more specific elements, accounts or items of a financial statement.

26. The table below highlights the position taken in the ISAs:

Assumption – Auditor concludes it is appropriate to issue an adverse opinion or disclaimer of opinion on the financial statements as a whole. Might it be appropriate to issue:			
	In the same report Ref ISA 705	**In a separate Report Ref ISA 805**	*Reasoning*
An unmodified opinion on a single financial statement?	No	No	Unmodified opinion considered contradictory since a single financial statement constitutes a major portion of a complete set of financial statements.
An unmodified opinion on one or more specific elements?	No	Yes (depends)	Unmodified opinion in the same report considered contradictory. May be appropriate in a separate report assuming not prohibited by law or regulation and specific element(s) does not constitute a major portion of the complete set of financial statements.

27. The requirement is now placed under the heading Other Considerations relating to an Adverse Opinion or Disclaimer of Opinion as the IAASB believed that ED-ISA 705 may have given too much prominence to the topic. Further clarification of what is not prohibited and why this is the case has been added in paragraph A16 of the revised ISA.

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

The Auditor’s Actions in the Case of a Management-Imposed Scope Limitation

28. Two respondents did not agree with paragraph 15 of ED-ISA 705 (now 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 are both material and pervasive to the financial statements and the auditor is unable to obtain the necessary evidence by performing alternative procedures.

29. 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.

This respondent believed that the requirement in the ISA for the auditor to communicate the scope limitation to those charged with governance before resigning is not enough and that it is important that the auditor issue a report that includes:

- A disclaimer of opinion; and
- A basis of modification paragraph that describes, as required by paragraph 23 of ED-ISA 705, 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).

30. The IAASB noted that the requirement giving the auditor the option to resign from the audit was a bold-letter requirement in the close-off document. Further, the application material to this requirement states that the timing of the auditor's resignation may depend on the stage of completion of the engagement at the time management imposed the scope limitation. When the audit is substantially complete, the application material suggests that the auditor may decide to complete the audit to the extent possible and disclaim an opinion and explain the scope limitation in the Basis for Disclaimer of Opinion paragraph prior to resigning.

31. In some jurisdictions auditors have a responsibility to communicate publicly when resigning from an audit engagement (e.g., via filings with securities regulators and others). In those jurisdictions that do not have such a requirement, when an auditor resigns from an audit engagement, there may be no transparency relating to the resignation. This may be a matter for future consideration by the IAASB, but is outside the scope of the redrafting of this ISA.

Multiple Uncertainties Leading to a Disclaimer

32. The guidance, included as paragraph A14 of ED-ISA 705, indicated:

> 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 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.

33. A few respondents commented that this guidance was not aligned with the objective and requirements of ED-705 (Revised and Redrafted) since, unlike other matters involving a disclaimer of opinion, in the case of multiple uncertainties the auditor has obtained sufficient appropriate audit evidence about management's assertion regarding each of the individual uncertainties but is unable to form an opinion on the financial statements as a whole due to the interaction and cumulative possible effects of the uncertainties.

34. Two respondents proposed that the requirement in paragraph 12 of ED-ISA 705 be expanded to specifically recognize multiple uncertainties as another circumstance when a disclaimer of opinion can be expressed.

35. 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 and not to detract from the general principles pertaining to disclaimers of opinion in the ISA. Accordingly, the IAASB dealt with material uncertainties in paragraph A14 of ED-ISA 705 as opposed to in the requirements.

36. In considering the comments received on exposure, the IAASB reconsidered this decision and decided to re-locate the material in paragraph A14 of ED-ISA 705 to paragraph 11 of the requirements in the final ISA to clarify that when multiple uncertainties exist (even though they are expected to be rare), it will be necessary for the auditor to disclaim an opinion on the financial statements. This avoids the possibility that Application and Other Explanatory Material might appear to contradict a requirement.

Disclosure of Omitted Information in the Auditor's Report

37. A few respondents questioned the appropriateness of the requirement in paragraph 21of ED-ISA 705. The requirement stated:

> 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.

38. 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 auditor to take on management's role and use the auditor's report as a vehicle for disclosures that should otherwise be provided 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.

39. One respondent was concerned that disclosures by the auditor could potentially confuse investors and the public as to the respective responsibilities of management and auditors and that it 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."

40. 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 that 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.

41. Two respondents suggested that the ISA should require the auditor to discuss the omitted disclosures with those charged with governance. The IAASB accepted this point, and revised the requirement to require the auditor to first discuss the non-disclosure with management and those charged with governance (see paragraph 21(a) of the final ISA). While the IAASB noted that this may be duplicative of the requirement in paragraph 28 of the final ISA, it was seen as a matter of emphasis given the sensitivity around the requirement for the auditor to include the omitted information in the auditor's report.

42. Given the extensive debate previously, and in light of the public interest considerations, the IAASB did not propose any further changes to the requirement, nor did it agree that the requirement to include the omitted disclosures in the auditor's report should be removed.