DRAFT OUTLINE OF

INTERNATIONAL STANDARD ON AUDITING XXX

FORMING AN OPINION ON THE FINANCIAL STATEMENTS

This agenda item is for reference purposes only.

The purpose of this paper is to provide a preliminary view of the possible structure and content of an ISA on *Forming an Opinion on the Financial Statements* and to help illustrate the choices discussed in the Issues Paper (see Agenda Item 5-A) regarding certain aspects of its structure and content.

The Task Force has not yet debated the detailed wording nor formed a view on the application of the Clarity drafting conventions to the text. Thus, it is not intended that there will be a detailed discussion of the wording at the September 2006 IAASB meeting.

Requirements and guidance in shading indicate wording for which it has to be decided whether the wording should be included in this new ISA. There are cross references to where the related issues are discussed in Agenda Item 5-A.

CONTENTS

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with forming an opinion on the financial statements, including evaluating audit evidence, evaluating whether the financial statements as a whole are free from material misstatement, and determining the type of opinion that is appropriate in the circumstances.

Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after [date].

Objectives

3. The objective of the auditor is to form an opinion on the financial statements, through:

   (a) Evaluating whether sufficient appropriate audit evidence has been obtained; and

   (b) Evaluating whether the financial statements as a whole are free from material misstatement.

Requirements

4. The auditor shall evaluate the conclusions drawn from the audit evidence obtained as the basis for forming an opinion on the financial statements. *[ISA 700 (Revised).11]*

5. The auditor shall apply analytical procedures at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity. (Ref: Para. A1). *[Extant ISA 520.13]* ***[Discussed in Agenda Item 5-A, B8]***

6. On the basis of audit evidence obtained, the auditor shall evaluate whether there is reasonable assurance about whether the financial statements taken as a whole are free from material misstatement (Ref: Para. A2-A3). This involves evaluating:

   (a) Whether sufficient appropriate audit evidence has been obtained; and

   (b) Whether the financial statements as a whole are free from material misstatement. *[Adapted from ISA 700 (Revised).12]*

Evaluating whether Sufficient Appropriate Evidence has been Obtained

7. The auditor shall conclude whether sufficient appropriate audit evidence has been obtained to reduce to an acceptably low level the risk that the financial statements as a whole are not free from material misstatements. ~~In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.~~ (Ref: Para. A4-6) *[Redrafted ISA 330.28 (September 2006). Note that the last sentence was deleted as it is repeated in paragraph 8 below.]* ***[Repositioning of text from ISA 330 is discussed in Agenda Item 5-A, B7]***

   [Paragraph 8 is discussed in Agenda Item 5-A, B9]

8. ~~In drawing reasonable conclusions on which to base the audit opinion on the financial statements,~~ The auditor shall consider all appropriate audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. The auditor shall use professional judgement and exercises professional skepticism in evaluating the quantity and quality of audit evidence and thus its sufficiency and appropriateness. The auditor shall not be satisfied with audit evidence that is less than persuasive. *[Staff Draft of Redrafted ISA500.13. The first sentence is deleted as it is repetitive of paragraph 7 above.]*

9. If the auditor has not obtained sufficient appropriate audit evidence, and further audit evidence cannot be obtained, the auditor shall consider the effect thereof on the opinion. *[Redrafted ISA 330.29 (September 2006)]*

Evaluating whether the Financial Statements as a Whole are Free from Material Misstatement

10. In evaluating whether the financial statements as a whole are free from material misstatement, the auditor shall consider both the results of the evaluation of the uncorrected misstatements and the qualitative aspects of the entity's accounting practices (Ref: Para. A15-A16). *[Latest Task Force Draft of Redrafted ISA 450.17]*

Evaluating the Effects of Uncorrected Misstatements Identified

[The shaded text in paragraphs 11-12 and the related application and other explanatory material is discussed in Agenda Item 5-A, B6]

11. The auditor shall evaluate whether uncorrected misstatements are material, individually or in aggregate. In making this evaluation, the auditor shall consider the size and nature of the misstatements, both in relation to particular classes of transactions, account balances and disclosures and the financial statements as a whole, and the particular circumstances of their occurrence. The auditor shall consider each misstatement separately to evaluate whether it is appropriate to offset misstatements, and the financial statement effect of classification misstatements. (Ref: Para. A7-A11) *[Latest Task Force Draft of Redrafted ISA 450.15]*

12. The auditor shall also consider the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. In this consideration, the auditor shall apply the same approach from period to period. (Ref: Para. A12) *[Latest Task Force Draft of Redrafted ISA 450.16]*

12a. ~~When forming an opinion as to whether the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework~~ The auditor shall evaluate whether the financial statements have been prepared and presented in accordance with the specific requirements of the applicable financial reporting framework for particular classes of transactions, account balances and disclosures. (Ref: Para. A13) *[Possible elevation from the first sentence of ISA 700 (Revised).13]*

Fair Presentation of the Financial Statements

13. When forming an opinion as to whether the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting

framework, the auditor shall also evaluate the fair presentation of the financial statements. (Ref: Para. A14 – A17) *[Possible elevation from the first sentence ISA 700 (Revised).14]*

Effect on the Audit Opinion

14. If the auditor concludes that, or is unable to conclude whether, the financial statements as a whole are materially misstated, including whether the financial statements give a true and fair view, or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework, when applicable, the auditor shall consider the effect thereof on the opinion. *[Latest Task Force Draft of Redrafted ISA 450.18]* ***[This paragraph represents the extent of the requirements on forming an opinion in Option 1 discussed in B5(a) of Agenda Item 5-A]***

Communication with Those Charged with Governance

[The shaded text in paragraphs 15-17 and the related application and other explanatory material is discussed in Agenda Item 5-A, B6]

15. The auditor shall communicate with those charged with governance[1] uncorrected misstatements and the effect that they may have on the auditor's report, and request their correction. The written representation obtained from management in accordance with ISA 450, paragraph 11, shall form part of this communication. In communicating the effect that material uncorrected misstatements may have on the auditor's report, the auditor shall address them individually. (Ref: Para. A18-A19) *[Latest Task Force Draft of Redrafted ISA 450.12]*

16. The auditor shall discuss with those charged with governance the reasons for, and the implications of a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, including possible implications in relation to future financial statements. *[Latest Task Force Draft of Redrafted ISA 450.13]*

17. The auditor shall communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. *[Latest Task Force Draft of Redrafted ISA 450.16a]*

Form of Opinion

[Paragraphs 18-19 below represent the extent of the requirements on forming an opinion that would be included in the new ISA under Option 2 discussed in B5(a) of Agenda Item 5-A]

Unmodified Opinion

18. The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework, including that the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting frameworks, when applicable. *[Adapted from ISA 700 (Revised).39]*

18a. ISA 700 (Revised), "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" deals with the form and content of an auditor's report with an unmodified opinion.

Modified Opinion

19. The auditor shall modify the opinion when:

    (a) The auditor concludes that, based on the audit evidence obtained, the financial statements are not free from material misstatement; or

    (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements are free from material misstatement. *[ISA 705.6 (July 2006 Close Off Document)]*

19a. ISA 705, "Modifications to the Opinion in the Independent Auditor's Report" deals with the form and content of the auditor's report with a modified opinion.

[Paragraphs 19-25 below represent the extent of the requirements on forming an opinion that would be included in the new ISA under Option 3 discussed in B5(a)]

Unmodified Opinion

18. The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework, including that the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting frameworks, when applicable. *[Adapted from ISA 700 (Revised).39]*

18a. ISA 700 (Revised), "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" deals with the form and content of an auditor's report with an unmodified opinion.

Modified Opinion

19. The auditor should modify the opinion in the auditor's report when:

    (a) The auditor concludes that, based on the audit evidence obtained, the financial statements are not free from material misstatement; or

    (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements are free from material misstatement. (Ref: Para. A20-A36) *[ISA 705.6 (July 2006 Close Off Document)]*

Qualified Opinion

20. The auditor shall express a qualified opinion when:

    (a) The auditor concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements. *[ISA 705.18 (July 2006 Close Off Document)]*

    (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the possible effects on the financial statements of that inability are material but not pervasive. *[ISA 705.27 (July 2006 Close Off Document)]*

Adverse Opinion

21. The auditor shall express an adverse opinion when the auditor concludes that misstatements, that are material individually or in the aggregate, are pervasive to the financial statements. *[ISA 705.20 (July 2006 Close Off Document)]*

Disclaimer of Opinion

22. 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 opinion, and the possible effects on the financial statements of that inability are pervasive. (Ref: Para. A15-A30) *[ISA 705.29 (July 2006 Close Off Document)]*

Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence due to a Management-imposed Limitation After the Auditor has Accepted the Engagement

23. If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit which the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor should request the removal of the limitation. If management refuses, the auditor should communicate the matter with those charged with governance and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence on which to base an unmodified opinion. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should determine the implications as follows:

    (a) If the possible effects of the scope limitation are material but not pervasive to the financial statements, the auditor should qualify the opinion; or

    (b) If the possible effects of the scope limitation are both material and pervasive to the financial statements so that a qualification of the opinion would be inadequate to communicate the gravity of the situation:

        (i) The auditor should resign from the audit; or

        (ii) If resignation from the audit before issuing the auditor's report is not practicable or possible, the auditor should disclaim an opinion.

    In relation to subparagraph (b)(i), if the auditor is aware of matters that would have given rise to a modification of the opinion regarding misstatements identified during the audit, the auditor should communicate such matters to those charged with governance before resigning. (Ref: Para. A37-38) *[ISA 705.31 (July 2006 Close Off Document)]*

Prohibition on Issuing a Piecemeal Opinion

24. If the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements as a whole, the auditor should not express an unmodified opinion on one or more specific elements, accounts or items in the financial statements in the same report and with respect to the same applicable financial reporting framework (a "piecemeal opinion"). (Ref: Para. A39-A40) *[ISA 705.35 (July 2006 Close Off Document)]*

24a. For the purpose of this ISA, a piecemeal opinion arises when the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements as a whole and, in the same report, expresses an unmodified opinion on one or more specific elements, accounts or items in the financial statements with respect to the same financial reporting framework. *[ISA 705.34 (July 2006 Close Off Document)]*

Communication with Those Charged with Governance ***[Discussed in Agenda Item 5-A, B5(b)]***

25. When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that lead to the expected modification and the proposed wording of the modification. (Ref: Para. A41) *[ISA 705.38 (July 2006 Close Off Document)]*

25a. ISA 705, "Modifications to the Opinion in the Independent Auditor's Report" deals with the content of the auditor's report with a modified opinion.

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Application and Other Explanatory Material

Analytical Procedures in the Overall Review at the End of the Audit

A1. As stated in ISA 520 '*Analytical Procedures'*, the conclusions drawn from the results of analytical procedures in the overall review at the end of the audit are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements and assist in arriving at the overall conclusion as to the reasonableness of the financial statements. However, they may also identify a previously unrecognized risk of material misstatement. In such circumstances, the auditor may need to re-evaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions. *[Extant ISA 520.13]*

Forming an Opinion

A2. As stated in ISA 200, "Objective and General Principles Governing an Audit of Financial Statements," the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework [*Extant ISA 200.2*].

A3. This involves evaluating whether, based on the audit evidence obtained, there is reasonable assurance about whether the financial statements taken as a whole are free from material misstatement. This involves concluding whether sufficient appropriate audit evidence has been obtained to reduce to an acceptably low level the risks of material misstatement of the financial statements and evaluating the effects of uncorrected misstatements identified. *[ISA 700 (Revised).12]*

Evaluating Whether Sufficient Appropriate Audit Evidence has been Obtained

A4. The quantity of audit evidence needed is affected by the risks of material misstatement; generally, the greater the risk, the more audit evidence is likely to be required. It is affected also by the quality of such audit evidence; generally, the higher the quality, the less may be required. Merely obtaining more audit evidence, however, may not compensate for its poor quality.

Consequently, the sufficiency and appropriateness of audit evidence are interrelated. *[Staff Draft of Redrafted ISA 500.A35]*

A5. The auditor's judgment as to the sufficiency of appropriate audit evidence is influenced by such factors as the following:

- Significance of the potential misstatement in the assertion and the likelihood of it having a material effect, individually or aggregated with other potential misstatements, on the financial statements.
- Effectiveness of management's responses and controls to address the risks.
- Experience gained during previous audits with respect to similar potential misstatements
- Results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.
- Persuasiveness of the audit evidence.
- Understanding of the entity, including its internal control, and its environment. *[Staff Draft of ISA 500.A36]*

A6. As indicated in paragraph A4, sufficiency and appropriateness are interrelated. Therefore, evaluation of sufficiency and appropriateness together is necessary in drawing reasonable conclusions on which to base the audit opinion. *[Staff Draft of ISA 500.A37]*

Evaluating Whether the Financial Statements as a Whole are Free from Material Misstatement

Evaluating the Effect of Uncorrected Misstatements

A7. Before considering the aggregate effect of uncorrected misstatements, each misstatement is considered separately to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions account balance or disclosure, if any, has been exceeded. *[Latest Task Force Draft of Redrafted 450.A13]*

A8. If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset immaterial misstatements within an account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting such immaterial misstatements is appropriate. *[Latest Task Force Draft of Redrafted 450.A13a]*[1]

A9. The determination of whether a classification misstatement is material requires the use of professional judgment and the evaluation of qualitative considerations, such as the effect of the classification misstatement on debt or other contractual covenants, the effect on individual line items or sub-totals on the effect on key ratios. There may be circumstances where the auditor

1 The identification of a number of immaterial misstatements within an account balance or class of transactions may require the auditor to reassess the risk of material misstatement for that account balance or class of transactions.

concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels applied in evaluating other misstatements. For example, a misclassification between balance sheet line items may not be considered material in the context of the financial statements as a whole when the amount of the misclassification is small in relation to the size of the related balance sheet line items and the misclassification does not affect the income statement or any key ratios. *[Latest Task Force Draft of Redrafted 450.A13b]*

A10. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than the materiality level for the financial statements as a whole (or for a particular class of transactions, account balance or disclosure, if any). Circumstances that may affect the evaluation include the extent to which the misstatement:

- Affects compliance with regulatory requirements;
- Affects compliance with debt covenants or other contractual requirements;
- Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements.
- Masks a change in earnings or other trends, especially in the context of general economic and industry conditions;
- Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
- Affects segment information presented in the financial statements (e.g., the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability);
- Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
- Is a misclassification between certain account balances affecting items disclosed separately in the financial statements (e.g., misclassification between operating and non-operating income or recurring and non-recurring income items; or a misclassification between restricted and unrestricted resources in a not-for-profit entity);
- Is significant having regard to the auditor's understanding of known previous communications to users, for example in relation to forecast earnings;
- Relates to items involving particular parties (e.g., whether external parties to the transaction are related to members of the entity's management);
- Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users' understanding of the financial position, financial performance or cash flows of the entity;

- Affects other information that will be communicated in documents containing the audited financial statements (e.g., information to be included in a "Management Discussion and Analysis" or an "Operating and Financial Review") that may reasonably be expected to influence the economic decisions of the users of the financial statements. ISA 720, "Other Information in Documents Containing Audited Financial Statements" deals with the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.

These circumstances are only examples; not all are likely to be present in all audits nor is the list necessarily complete. The existence of any circumstances such as these does not necessarily lead to a conclusion that the misstatement is material. *[Latest Task Force Draft of Redrafted ISA 450.A14]*

A11. ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements" explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the effect of the misstatement is not material to the financial statements. *[Latest Task Force Draft of Redrafted ISA 450.A15]*

A12. The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. There are different acceptable approaches to this consideration. Whichever approach is followed by the auditor, it is important that it be followed consistently from period to period. *[Latest Task Force Draft of Redrafted ISA 450.A16]*

A13. When forming an opinion as to whether the financial statements ~~give a true and fair view or are presented fairly~~ have been prepared, in all material respects, in accordance with the applicable financial reporting framework, the auditor ~~will~~ evaluates whether the financial statements have been prepared and presented in accordance with the specific requirements of the applicable financial reporting framework for particular classes of transactions, account balances and disclosures. This evaluation includes considering whether, in the context of the applicable financial reporting framework:

(a) The accounting policies selected and applied are consistent with the financial reporting framework and are appropriate in the circumstances;

(b) The accounting estimates made by management are reasonable in the circumstances;

(c) The information presented in the financial statements, including accounting policies, is relevant, reliable, comparable and understandable; and

(d) The financial statements provide sufficient disclosures to enable users to understand the effect of material transactions and events on the information conveyed in the financial statements, prepared in accordance with International Financial Reporting Standards (IFRSs), the entity's financial position, financial performance and cash flows. *[ISA 700 (Revised).13]*

Fair Presentation of the Financial Statements

A14. Forming an opinion as to whether the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework also involves evaluating the fair presentation of the financial statements. The auditor considers whether the financial statements, after any adjustments made by management as a result of the audit process, are consistent with the auditor's understanding of the entity and its environment. The auditor also considers the overall presentation, structure and content of the financial statements, including the note disclosures, faithfully represent the underlying transactions and events in a manner that gives a true and fair view of or presents fairly, in all material respects, the information conveyed in the financial statements in the context of the financial reporting framework. Analytical procedures performed at or near the end of the audit help to corroborate conclusions formed during the audit and assist in arriving at the overall conclusion as to the fair presentation of the financial statements. *[ISA 700 (Revised).14]*

Considering the Qualitative Aspects of the Entity's Accounting Practices

A15. In considering the qualitative aspects of the entity's accounting practices, the auditor recognizes that management makes a number of judgments about the amounts and disclosures in the financial statements. During the audit, the auditor is alert for possible bias in management's judgments. The auditor may conclude that the cumulative effect of a lack of neutrality, together with the effect of uncorrected misstatements, cause the financial statements as a whole to be materially misstated. Indicators of a lack of neutrality that may affect the auditor's evaluation whether the financial statements as a whole are materially misstated include the following:

- The selective correction of misstatements brought to management's attention during the audit (e.g., correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings).
- Possible management bias in the making of accounting estimates. *[Latest Task Force Draft of Redrafted ISA 450.A19]*

A16. [Proposed] ISA 540 (Revised), "Auditing Accounting Estimates and Related Disclosures (Other Than Those Involving Fair Value Measurements and Disclosures)" addresses possible management bias in making accounting estimates. Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement. *[Latest Draft of Redrafted ISA 450.A20]*

Extremely rare circumstances when applying the financial reporting framework results in misleading financial statements

A17. As discussed in ISA 210, the auditor considers the acceptability of the financial reporting framework when considering accepting the engagement. Application of a financial reporting framework determined to be acceptable for general purpose financial statements will ordinarily result in financial statements that achieve fair presentation. In extremely rare circumstances, however, application of a specific requirement in a framework that has been determined to be acceptable for general purpose financial statements may result in financial statements that are misleading in the particular circumstances of the entity. Some financial reporting frameworks determined to be acceptable for general purpose financial statements acknowledge, implicitly or explicitly, that there are extremely rare circumstances when it is necessary for the financial statements to depart from a specific requirement in the framework in order to achieve the objective of fair presentation of the financial statements and provide guidance on the disclosures required. Other financial reporting frameworks may not provide any guidance on these circumstances even though they are acceptable frameworks or general purpose financial statements. If the auditor encounters circumstances that lead the auditor to conclude that compliance with a specific requirement results in financial statements that are misleading, the auditor considers the need to modify the auditor's report. The modifications, if any that are appropriate to the auditor's report will depend on how management addresses the matter in the financial statements and how the financial reporting framework with these rare circumstances (see ISA 701). *[ISA 700 (Revised).15]*

Communication with Those Charged with Governance (Ref: Para. 12-13)

A18. Where there are a large number of small uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement. *[Latest Task Force Draft of Redrafted ISA 450.A9]*

A19. To reduce the possibility of misunderstandings, the auditor may request a written representation from those charged with governance that explains why uncorrected misstatements brought to their attention have not been corrected. Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements. *[Latest Task Force Draft of Redrafted ISA 450.A10]*

Form of Opinion

Modified Opinion

Determining the Type of Modification to the Auditor's Opinion

A20. This ISA establishes three types of modified opinions, namely, a qualified opinion, an adverse opinion, and a disclaimer of opinion. The decision regarding which type of modified opinion is appropriate depends upon:

(a) The nature of the matter giving rise to the modification, i.e., whether the financial statements are materially misstated or whether there is an inability to obtain sufficient appropriate audit evidence; and

(b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements. *[ISA 705.7 (July 2006 Close Off Document)]*

A21. 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. *[ISA 705.8 (July 2006 Close Off Document)]*

Nature of Matter Giving Rise to the Modification	Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements

	Material but not Pervasive	Pervasive
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

A23. The auditor may judge misstatements that are material individually or in the aggregate to be pervasive to the financial statements when such misstatements 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. *[ISA 705.9 (July 2006 Close Off Document)]*

A24. Further, in relation to disclosures, the auditor may judge misstatements that are material individually or in the aggregate to be pervasive to the financial statements when the misstated disclosures are fundamental to users' understanding of the financial statements. *[ISA 705.10 (July 2006 Close Off Document)]*

Pervasiveness of the Matter or Matters Giving Rise to a Modification—Inability to Obtain Sufficient Appropriate Audit Evidence

A25. The auditor may judge an inability to obtain sufficient appropriate audit evidence about one or more matters pertaining to the financial statements to be pervasive when the effects of the inability cannot be confined to specific elements, accounts or items in the financial statements or, if confined, the effects of the inability could represent a substantial proportion of the financial statements. *[ISA 705.11 (July 2006 Close Off Document)]*

Multiple Uncertainties

A26. 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. Accordingly, in such a situation, the auditor may determine that a disclaimer of opinion is appropriate. *[ISA 705.12 (July 2006 Close Off Document)]*

Financial Statements are Materially Misstated

A27. A material misstatement of the financial statements may arise in relation to:

(a) The appropriateness of the selected accounting policies;

(b) The application of the selected accounting policies; or

(c) The appropriateness or adequacy of disclosures in the financial statements. *[ISA 705.13 (July 2006 Close Off Document)]*

Appropriateness of the Selected Accounting Policies

A28. In relation to the appropriateness of the accounting policies management has selected, material misstatements of the financial statements may arise when:

- The selected accounting policies are not consistent with the applicable financial reporting framework.
- The selected accounting policies are not appropriate in the circumstances and, accordingly, the overall presentation of, and disclosures in, the financial statements are not consistent with the auditor's understanding of the entity and its environment.
- Because of the accounting policies selected by management, the financial statements, including the disclosures, do not faithfully represent the underlying transactions and events in a manner that gives a true and fair view of (or presents fairly, in all material respects) the information in the financial statements. *[ISA 705.14 (July 2006 Close Off Document)]*

A29. Financial reporting frameworks often contain requirements for the accounting for, and disclosure of, changes in accounting policies. Where the entity has changed its selection of significant accounting policies, a material misstatement of the financial statements may arise when the entity has not complied with these requirements. *[ISA 705.15 (July 2006 Close Off Document)]*

Application of the Selected Accounting Policies

A30. In relation to the application of the selected accounting policies, material misstatements of the financial statements may arise:

- When management has not applied the selected accounting policies consistently with the financial reporting framework, including applying the selected accounting policies consistently between periods or to similar transactions and events (consistency in application); or
- Due to the method of application of the selected accounting policies (error in application), such as when there is a disagreement with management about the underlying facts and circumstances to which the selected accounting policies are applied (for example, a disagreement about estimates for pension liabilities). *[ISA 705.16 (July 2006 Close Off Document)]*

Appropriateness or Adequacy of Disclosures in the Financial Statements

A31. In relation to the appropriateness or adequacy of disclosures in the financial statements, material misstatements of the financial statements may arise when:

(a) The financial statements do not include all of the disclosures required by the applicable financial reporting framework;

(b) The disclosures in the financial statements are not presented in accordance with the applicable financial reporting framework; or

(c) The financial statements do not provide the disclosures necessary to achieve fair presentation. *[ISA 705.17 (July 2006 Close Off Document)]*

Inability to Obtain Sufficient Appropriate Audit Evidence

A32. The auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from:

(a) Circumstances beyond the control of the entity;

(b) Circumstances relating to the nature or timing of the auditor's work; or

(c) Limitations imposed by management. *[ISA 705.22 (July 2006 Close Off Document)]*

A33. An inability to perform a specific procedure does not constitute a scope limitation if the auditor is able to obtain sufficient appropriate audit evidence by performing alternative procedures. If this is not possible, the auditor qualifies the opinion or disclaims an opinion. Limitations imposed by management may have other implications for the audit, for example, the auditor's assessment of fraud risks and consideration of engagement continuance. *[ISA 705.23 (July 2006 Close Off Document)]*

A34. Examples of circumstances beyond the control of the entity include:

- When the entity's accounting records have been destroyed.
- When the accounting records of a significant component based in a foreign jurisdiction have been seized indefinitely by governmental authorities in that jurisdiction. *[ISA 705.24 (July 2006 Close Off Document)]*

A35. Examples of circumstances relating to the nature or timing of the auditor's work include:

- When the auditor determines that performing substantive procedures alone are not sufficient, but the entity's controls are not effective.
- When the entity is required to use the equity method of accounting for an associated entity, and the auditor is unable to obtain sufficient appropriate audit evidence about the latter's financial information to examine the application of the equity method.
- When the timing of the auditor's appointment is such that the auditor is unable to observe the counting of the physical inventories. *[ISA 705.25 (July 2006 Close Off Document)]*

A36. Examples of an inability to obtain sufficient appropriate audit evidence arising from a scope limitation imposed by management include:

- When management prevents the auditor from observing the counting of the physical inventory.
- When management prevents the auditor from requesting external confirmation of specific account balances. *[ISA 705.26 (July 2006 Close Off Document)]*

Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence due to a Management-imposed Limitation After the Auditor has Accepted the Engagement

A37.The timing of the auditor's resignation may depend upon the stage of completion of the engagement when management imposes the scope limitation. If the auditor has substantially completed the audit, the auditor may decide to complete the audit to the extent possible, disclaim an opinion and explain the scope limitation in the Basis for Disclaimer of Opinion paragraph prior to resigning. *[ISA 705.32 (July 2006 Close Off Document)]*

A38.In certain circumstances, resignation from the audit may not be possible if the auditor is required to continue the audit engagement by law or regulation. This may be the case for national audit agencies that are appointed to audit the financial statements of public sector entities, or in jurisdictions where the auditor is appointed for a specific period and is prohibited from resigning before the end of that period. In such cases, the appropriate response for the auditor to a scope limitation imposed by management is to disclaim an opinion on the financial statements. *[ISA 705.33 (July 2006 Close Off Document)]*

Prohibition on Issuing a Piecemeal Opinion

A39.Specific elements, accounts or items in the financial statements may include, for example, the revenue item in the income statement, or specific disclosures in the financial statements. A combination of an unmodified opinion on one or more of these specific elements, accounts or items, and an adverse opinion or a disclaimer of opinion on the financial statements as a whole, in the same report and with respect to the same financial reporting framework, is contradictory. It is accordingly not permitted. *[ISA 705.36 (July 2006 Close Off Document)]*

A40.The description of "piecemeal opinion" does not include, for example:

- The expression of an unmodified opinion on financial statements prepared under a given financial reporting framework and, within the same report, the expression of an adverse opinion or the issue of a disclaimer of opinion on the same financial statements under a different financial reporting framework. For example, the auditor may express an adverse opinion on financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation, and within the same report, express an unmodified opinion with respect to the proper preparation of the financial statements in accordance with specific legal requirements not designed to achieve fair presentation.
- The expression of an unmodified opinion on the closing financial position of the entity but a disclaimer of an opinion on the results of operations and cash flows if the auditor has been unable to obtain sufficient audit evidence concerning the entity's opening balances (see paragraph 11(c) of ISA 510, "Initial Engagements–Opening Balances").*[ISA 705.37 (July 2006 Close Off Document)*]

Communication with Those Charged with Governance

A41.Communicating with those charged with governance the circumstances that lead to the expected modification and proposed wording of the modification enables:

(a) Those charged with governance to be made aware of the expected modification(s) and the reasons (or circumstances) for the modification(s);

(b) The auditor to agree the facts in respect of the matter(s) giving rise to the expected modification(s), or to confirm matters of disagreement with management as such; and

(c) Those charged with governance to have an opportunity, where appropriate, to provide the auditor with further information and explanations in respect of the matter(s) giving rise to the expected modification(s). *[ISA 705.39 (July 2006 Close Off Document)]*