

IAASB Project Proposal—Modifications to the Auditor’s Report**1. Subject**

New ISA on modifications to the auditor’s report revising the structure of, and basic principles and guidance in, extant ISA 700.

2. Reasons the Subject Should Be Studied Now

REVISION OF ISA 700, THE AUDITOR’S REPORT ON FINANCIAL STATEMENTS

The IAASB approved in June 2002 a project for the revision of ISA 700, *The Auditor’s Report on Financial Statements*, that proposed to focus revision efforts on the basic elements of the auditor’s report and the illustrated auditor’s report. This project was not intended to address the structure of, and basic principles, in the section of extant ISA 700 on modified reports (e.g. qualified opinions, disclaimer of opinion, adverse opinions and emphasis of matter paragraphs). This scoping decision was made based on the view that including issues related to modified reports in the ISA 700 project would expand its scope significantly and could jeopardize the IAASB’s ability to complete the project before 2005.

In March 2003, the IAASB agreed on a strategy to revise the guidance on modified reports in extant ISA 700 following a “two-phase” approach:

- *Phase I:* Split extant ISA 700, placing or “carving out” the existing guidance on modified reports in a newly proposed ISA 701, *Modifications to the Auditor’s Report*. Only the minimal changes necessary would be effected to the existing guidance on modified reports in order to accomplish this split. Proposed new ISA 701 would then be exposed as a ‘conforming change’ at the same time as the issuance of revised ISA 700 (October 2003). This approach provides greater clarity to the nature and extent of revisions to ISA 700 on unmodified reports.
- *Phase II:* Fundamental review and revision of the structure of, and principles and guidance on, modified reports in ISA 701.

The IAASB Reporting Task Force has agreed to assume responsibility for Phase I noted above. The initial split of ISA 700 into ISA 700 and ISA 701, and the related conforming changes, will be issued as part of the ED of revised ISA 700. The Reporting Task Force will be responsible for determining the necessary conforming changes and to deal with the ED responses in a consistent and comprehensive manner.

With the anticipated split of ISA 700, it is important that the IAASB addresses the matter of modified reports in a comprehensive and timely manner. Strategically, it behoves the IAASB to be in a position to communicate that it has commenced a project to revise the guidance on modified reports (Phase II) as soon as possible but no later than when the revised ISA 700 on unmodified reports is exposed.

DEMAND FOR ADDITIONAL GUIDANCE AND CONSISTENCY IN REPORTING

A significant part of extant ISA 700 guidance relating to modified reports has not been revised since the original issuance of the Standard in October 1992. There is a greater discretionary

factor present when, and variation in the circumstances in which, modifications are made and, accordingly, further guidance and consistency in modified reports may be desirable.

Some IAASB members expressed the view that additional and revised guidance was needed on modified reports. The types of issues raised by some IAASB members with respect to modified reports include additional clarification on the use of emphasis of matter paragraph, practical guidance based on the existing framework when deciding on the nature of the modification to the auditor's report, and how situations of uncertainty should be dealt with.

Consistent, clear and generally accepted reporting guidance will be important to an increasing number of auditors who will be looking to the ISAs for guidance on the form and content of, and the situations that require, modifications to the auditor's report.

GUIDANCE ON MODIFIED REPORTS WITHIN OTHER ISAS

Guidance in the ISAs on how the auditor forms his or her opinion on whether the auditor's report would be modified is dispersed in a number of areas in the ISAs. There are currently 14 ISAs, as well as the Audit Risk ED, which identify reporting implications arising from specific considerations in the audit. It is important to consider whether the guidance in extant ISA 700 on modified reports is sufficiently robust and consistently provides guidance to the auditor when directed to the Standard by other ISAs.

3. Scope of Project

(a) LIST THE MAJOR PROBLEMS AND ISSUES THAT SHOULD BE ADDRESSED

The proposed project strategy is outlined in *Section I – Project Strategy* in this project proposal.

The issues that need to be addressed in the revision of guidance on modifications to the auditor's report are included in *Section II – Revision of Guidance on Modifications to the Auditor's Report*, grouped under the following categories:

- a. Objectives and scope
- b. Emphasis-of-Matter modifications
- c. Matters that do affect the auditor's report
 - i. Disagreement with management
 - ii. Scope limitation
- d. Modifications to the auditor's report
 - i. Qualified opinion
 - ii. Adverse opinion
 - iii. Disclaimer of opinion
- e. Reporting
- f. Additional matters for consideration

I. PROJECT STRATEGY

As indicated above, the strategy to revise the guidance on modified reports in extant ISA 700 would follow a “two-phase” approach:

Phase I:

- Spit extant ISA 700, placing or “carving out” the existing guidance on modified reports in a newly proposed ISA 701, *Modifications to the Auditor’s Report*.
- Phase I will be undertaken by the Reporting Task Force.
- Four important aspects will be considered when establishing new ISA 701 under this phase:

Set-up of ISA 701 The way in which proposed ISA 701 is set up and the guidance provided to the reader on the application of, and relationship between, ISA 700 and ISA 701 are critical to acceptance of the proposed approach. Careful attention will be directed towards drafting introductory paragraphs to both revised ISA 700 and new ISA 701 to establish this relationship and appropriately direct the reader. New ISA 701 will be constructed as a stand-alone Standard with only necessary cross-references to ISA 700 to minimize repetition of guidance on the components of the auditor’s report and related reporting considerations.

Conformity with proposed ISA 700 Conforming amendments to the guidance and illustrative examples in extant ISA 700 on modified reports arising from proposed changes to the guidance on the auditor’s unmodified report in proposed ISA 700 will be necessary. The nature and extent of these conforming changes will be determined as the drafting of revised ISA 700 progresses.

Communication Additional communication clarifying the approach to the revision process, and to explain how the current guidance on modified reports fits with revised ISA 700, may be necessary. This may take the form of an explanatory memorandum or background discussions in the introductory sections of the exposure drafts of revised ISA 700 and new ISA 701.

A consequence of this “staggered” approach to the revision of ISA 700 is that exposure of fundamental revisions to guidance on modified reports (see Phase II below) can only take place after final approval of revised ISA 700 and new ISA 701 under Phase I.

Phase II:

- *Phase II:* Fundamental review and revision of the structure of, and principles and guidance on, modified reports in ISA 701 based on the issues identified in section II of this project proposal.
- A new Task Force will need to be established to revise the guidance on modified reports.

Details on the proposed timetable for issuance of ISA 701 under Phase I and II are included in **section 4** of this proposal.

PHASE II – REVISION OF GUIDANCE ON MODIFICATIONS TO THE AUDITOR'S REPORT:

A summary of the issues, in priority order and by topic area, to be addressed in the revision of the guidance on modifications to the auditor's report is set out below.

(A) OBJECTIVES AND SCOPE:

Objectives:

The objectives of revision to guidance on modified audit reports are to:

- Increase the **consistency in reporting among jurisdictions**. Modifications to auditors' reports for audits conducted in accordance with ISAs should be consistent and be readily identifiable. New ISA 701 should therefore be more directive in specifying the form, content and wording of a modified auditor's report for audits conducted in accordance with ISAs.
- Increase the **understandability** of the auditor's role and of the auditor's report when modifications are made.
- Enhance the **relevance and usefulness** of guidance illustrating when modifications are needed and how the auditor's report should be modified in particular circumstances.

Scope:

I. Basis for conclusions:

In February 2003, IAASB members were requested for input on the nature of issues to be addressed on modified reports. Based on the range of suggestions and comments that IAASB members provided, two very distinct views come across: those seeking clarification of the guidance on the existing conceptual model for modifications (for example, additional guidance on emphasis of matter paragraphs); to those proposing the need for broad-based academic research to support decisions regarding the efficacy and adequacy of the basic framework in the ISA for modifications.

The issue of whether longer term academic research is needed to open the debate on more fundamental issues regarding the product of an audit and whether any such research should be conducted prior to, sequentially with, or subsequent to the commencement of the revision of guidance on modified reports is difficult to answer. One view is that the clarity of the scope and nature of issues that may need to be addressed through academic research may only be fully understood after deliberation of issues at the IAASB Task Force level. Alternatively, soundly-designed research may benefit the overall approach to the revision of guidance on modified reports and may avoid the need to subsequently re-open the ISA. This alternative, however, risks that research is commissioned on an incomplete set of issues, and would significantly delay the development of IAASB guidance on the subject of modifications to auditor's reports.

To retain the manageability of this project, this project proposal is positioned to only addresses initiatives (e.g., expanding, clarifying, and re-considering the guidance on the existing basic framework for modifications) that presumably may be handled by an IAASB Task Force without significant academic research to meet the present need for additional practical guidance. That is, academic research on such fundamental issues will not form a significant component of the scope of this project. However, if the assigned Task Force identifies areas that would benefit from, or indeed require, longer term academic research, these matters will be identified and brought forward to the IAASB for considered of the need for academic assistance.

II. *Scope exclusions:*

The project will not address matters that are excluded from the scope of the revision to ISA 700 on unmodified reports, including:

- How the auditor should report when he or she has identified an event or condition that may cast significant doubt on the entity's ability to continue as a going concern but is satisfied that management's plans for future actions mitigate the risk.
- Whether the auditor's report on a single financial statement (e.g., a balance sheet) should be modified to indicate that other primary financial statements are not presented.
- Modified reports in the circumstances described in ISA 710, *Comparatives*, other than for consequential conforming changes. It is recommended that reporting issues, if any, related to comparatives should be addressed separately as and when IAASB has the resources and agenda time available.
- Other reporting issues related to special purpose audit engagements, review engagements, and engagements for which ISAs do not yet provide any guidance. It is recommended that these other reporting issues should be addressed separately as and when IAASB has the resources and agenda time available.

(B) **EMPHASIS-OF-MATTER MODIFICATIONS**

The position adopted in ISA 700 regarding an emphasis of matter can be summarized as follows:

	Material but not Extreme	Extreme Cases
Inherent uncertainty: going concern question	unqualified opinion, with an emphasis of matter, is required	Unqualified opinion with an emphasis of matter, or inability to form an opinion, is required
Inherent uncertainty: other than a going concern question	unqualified opinion is required, an emphasis of matter may be added	Unqualified opinion with an emphasis of matter, or inability to form an opinion is required
Any other matter that does not result in a qualification	unqualified opinion is required, an emphasis of matter may be added	Unqualified opinion is required, an emphasis of matter may be added

Some concern has been expressed that the current guidance on emphasis of matter may be inadequate to achieve consistency in reporting and provide clarity in the circumstances under which it should be used. Several options exist to address this, including:

- Restrict and mandate the situations when emphasis of matter should be provided.

Because an emphasis of matter may be misinterpreted as a qualification, it may be appropriate that it should only apply in certain limited circumstances that do not affect the auditor's opinion. An inability for the auditor to form an opinion would then not arise in the extreme cases.

To ensure consistency, it may also be appropriate to mandate the use of emphasis of matter in those limited circumstances.

- Retain the current guidance (see chart above) but expand it on the situations where an emphasis of matter may be added.
- Include additional situations where an emphasis of matter is required and also expand the guidance on situations where an emphasis of matter may be added.

The proposed approach would follow the third option above – consistency would be enhanced if additional areas are identified for mandatory emphasis of matter paragraphs. It would also retain the current flexibility for auditor's to address other matters through the emphasis of matter paragraph that are, in their judgment, important given the particular circumstances of each engagement.

In relation to the above, **Appendix A** identifies and describes the areas that would be considered by the project as either an additional matter which the auditor would be required to report on or as additional guidance to assist the auditor in making a determination on other matters to be communicated.

(C) MODIFICATIONS OTHER THAN EMPHASIS OF MATTER

Extant ISA 700 defines when a qualified opinion is necessary (¶36). Based on that guidance, the auditor considers whether:

- there has been a limitation on his scope of work;
- there are any disagreements with management regarding the acceptability of the accounting policies selected;
- there are any disagreements with management regarding the method of application of the accounting policies; and
- there are any disagreements with management regarding the adequacy of financial statement disclosures.

(I) DISAGREEMENT WITH MANAGEMENT

Determining whether ISA 700 appropriately defines “disagreement with management” and sufficiently guides the auditor in determining what this constitutes:

Modification to the auditor's report as a result of a disagreement with management is a highly important area generally involving the greatest amount of judgment by the auditor. Firms' quality control programs are placing heightened attention on the auditor's judgments and reporting decisions in such circumstances, given recent major corporate failures. There are numerous issues that would need to be considered in revising guidance on determining whether the auditor should consider if there is a disagreement with management and how to modify the auditor's report. **Appendix B** identifies and describes these issues.

(II) SCOPE LIMITATION

Extant ISA 700 characterizes a scope limitation as “limitation on the scope of the auditors work” or when the “auditor is unable to carry out an audit procedure believed to be desirable”. The project would consider whether extant ISA 700 sufficiently defines what constitutes a “limitation on scope”, and whether additional guidance is needed to assist the auditor in assessing whether to qualify his or her opinion or disclaim an opinion, including the importance of the omitted procedure(s) to the auditor's ability to form an opinion. **Appendix C** identifies and describes the issues, in addition to the above, that would be considered by the project on the subject of guidance on scope limitations.

(D) MODIFICATIONS TO THE REPORT**(I) QUALIFIED OPINIONS**

Determining the need for a qualified opinion and deciding between a qualified opinion and an adverse or disclaimer of opinion

Extant ISA 700 does not specifically discuss the application or exercise of professional judgment and its importance in determining the type of auditor's report that is appropriate in the circumstances. However, this is clearly the most important aspect when considering the nature of a qualification (i.e. between a qualified opinion and an adverse or disclaimer of opinion). The current guidance does not extend significantly beyond the one deciding factor: the degree to which the disagreement or scope limitation is material and pervasive.

Additional guidance on determining the nature of the qualification would enhance consistency of application, such as clarifying when modifications are needed and how the auditor's report should be modified in particular circumstances.

Appendix D identified and describes issues with respect to the above and other very challenging issues that would be considered by the project.

(II) ADVERSE OPINION

Extant ISA 700 paragraph 40 requires the auditor to provide a "clear description of all the substantive reasons" whenever the auditor expresses an opinion that is other than unqualified. While this imperative is clear with respect to expressing a qualified opinion, it is possible that some reports may only include a description of disagreements with management that give rise to an adverse or disclaimer of opinion and exclude other matters that, in and of themselves, would constitute a qualification. The project will consider whether additional guidance is needed to clarify the auditor's responsibility for disclosure of all identified matters that have influenced the decision of the auditor.

(III) DISCLAIMER OF OPINION

In the case of a disclaimer of opinion, the project will consider whether:

- the Standard should explicitly prohibit the auditor from indicating the specific procedures performed because this may tend to overshadow the disclaimer.
- additional guidance on the content of a disclaimed opinion is needed.
- additional guidance is needed in the rare circumstances where it may not be possible or practical for the auditor to complete the audit, either at the direction of the entity or as a result of problems encountered

(E) EXAMPLE REPORTS

The wording of example modifications to the auditor's report for emphasis of matter paragraphs, and qualified, adverse and disclaimer of opinions will be reviewed by comparison with practice in various countries. The wording will be reviewed to ensure consistency, clarity and understandability. Additional examples of modifications will be prepared to illustrate the principles and guidance in new ISA 701.

(F) OTHER MATTERS FOR CONSIDERATION

Other matters that the project would consider are listed and described in **Appendix E**.

(B) DESCRIBE ANY IMPLICATIONS FOR PERSONS OR GROUPS OTHER THAN THE BOARD
Once ISA 701 has been issued, the Education Committee may need to revise some of its material.

CAG should be advised and consulted and provided with early communication of issues identified, including matters that may be particularly relevant to the European Union countries and its planned adoption of ISAs in 2005.

(c) CONSIDER WHETHER INFORMATION TECHNOLOGY (IT) REQUIRES PARTICULAR CONSIDERATION

No

4. Indicate the Type of Material to Be Published

New ISA 701 and any necessary supporting guidance:

Phase I: Establishment of ISA 701 and placing the existing guidance on modified reports in new ISA 701 with only the minimal changes necessary.

The Phase would be accomplished by the existing IAASB Reporting Task Force.

ISA 701 would be exposed as part of the revised ISA 700 exposure draft as a proposed conforming change. The exposure draft communication would express the intention of the split and how ISA 701 fits with revised ISA 700. Specific comments on new ISA 701 would not be requested. The timetable for exposure of ISA 701 under this phase would follow the schedule for revision of ISA 700, as follows:

Exposure draft	October 2003
Approved	June 2004
Effective date	No later than January 1, 2005

Phase II: Revision of the structure, principles and guidance on modified reports in the newly established ISA 701.

This Phase would be accomplished by a newly created Task Force established to address the issues in this project proposal.

Given the nature and breadth of issues to be addressed in this project, a creation of a Task Force to begin considering the issues and developing guidance should be undertaken as soon as possible.

Once revised ISA 700 and proposed ISA 701 (under Phase I) are approved in June 2004, the proposed revision of ISA 701 would be issued for exposure immediately thereafter. This is necessary in order to ensure ISA 701 is consistent with the final ISA 700 and to permit the issuance of an exposure draft on an established ISA (that is, we cannot expose revision to ISA 701 until it has authority).

Creation of Task Force	July 2003
Exposure draft	June 2004
Approved	March 2005
Effective date	No later than January 1, 2006

5. Resources Required

Given the importance of the guidance and form of modifications to auditor's report in communicating conclusions of auditors, it is important to ensure that a broad international perspective is brought to bear in the project. To ensure that broad input, composition of the Task Force might include (one of which would be the Task Force Chair) a combination of IAASB members, technical advisors and non-members and the IAASB Technical Director (ex officio). This Task Force should consider including individuals from the EU, small practices, major capital markets and national standard setters.

Ideally, a member(s) of the present Task Force addressing the revision of ISA 700 would be assigned to or be closely involved with this Task Force to provide continuity of knowledge and sharing of experience gained on the ISA 700 project. This would also assist in consistency in drafting and approach in addressing and disposing of related issues.

In order to deal with the range of issues that need to be addressed by June, 2004, it is proposed that the Task Force be assigned a drafting team rather than just one staff member. Individual members of team could be assigned responsibility for working on one or more of the various separable topics under the coordination of the Task Force Chair. Since many of the issues identified in the appendices are practice issues, it is recommended that the drafting team include individuals who have actual experience in addressing these types of issues in practice. If the overall approach to the project is approved, it would be appropriate to ask the larger firms to provide staff resources for the drafting team. Involving the firms in developing solutions to the practical reporting issues might have the added benefit of helping to harmonize practice as the revisions to the ISAs are in process.

6. List Important Sources of Information That Address the Matter Being Proposed

- Existing ISAs and reporting guidance in national standards
- Firms' reporting policies and internal guidance
- FEE study, "The Auditor's Report in Europe", 15 June 2000

7. Factors That May Add To Complexity or Length of Project

- While revisions to the ISA 700 and 800 can influence audit reports in engagements performed in compliance with the ISAs, effecting full change in reporting practice depends on national standard setters making corresponding changes to their own national standards. Changes may also be needed to regulation and governing legislation if they dictate the form and content of modifications to the auditor's report.
- Issues that are identified as requiring academic research as a prerequisite to their resolution would increase the scope, complexity and length of the project.
- Issues for which there is not yet consensus at a national standards level currently could increase both the complexity and length of the project.
- There are a number of concurrent IAASB projects that might have implications for the nature of guidance and wording of modifications to the auditor's report, including, for example, the audit risk model, fraud, materiality and accounting estimates projects. Prompt identification of matters arising from those projects that are relevant to the revisions to ISA 701 under Phase II is important and close coordination among the projects will be vital.

- The issuance of new ISA 701 is heavily dependent on the findings and success of the ISA 700 Task Force. Issues and difficulties encountered in ISA 700 may similarly arise in this ISA 701 project.

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Appendix A - Issues Pertaining to Emphasis of Matter Modifications

Matter	Issues for consideration
<i>Significant Uncertainty</i>	<p>Concern has been expressed as to whether existing guidance in ISA 700 is appropriate and adequate for an emphasis of matter when there is a significant uncertainty (other than a going concern problem), the resolution of which is dependent upon future events, and which may affect the financial statements. Issues to be addressed include:</p> <ul style="list-style-type: none"> • How current guidance is being applied in practice to highlight certain circumstances, for example, unrecorded contingencies or estimates with measurement uncertainty, and whether it is being applied consistently. • Whether a re-definition of, or additional guidance as to what constitutes, significant uncertainty is needed to enhance consistency in reporting. • Whether existing guidance is sufficient to make it clear when an emphasis of matter would be inappropriate in the absence of proper evidence. For example, rather than make a provision, a client may disclose some uncertainty over the recovery of debt. In this regard, it is unclear whether the auditor should be content with an emphasis of matter paragraph. <p>Such matters are also being contemplated by the Task Force on Estimates, whose findings may have implications here.</p>
<i>Multiple uncertainties</i>	<p>The current guidance in ISA 700 on multiple uncertainties is very limited. Issues to be addressed include whether:</p> <ul style="list-style-type: none"> • additional guidance is needed to better define or illustrate “extreme cases involving multiple uncertainties that are significant to the financial statements” • factors or criteria should be provided to assist the auditor in determining whether a disclaimer of opinion or an emphasis of matter should be reported.
<i>Inconsistent other information</i>	<p>Whether the current guidance in ISA 700 paragraph 35 should be required in all circumstances and, accordingly, established as a basic principle. This may also increase the consistency in guidance with ISA 720 paragraph 13.</p>
<i>Inappropriateness of going concern as a result of new conditions after reporting date</i>	<p>Whether the auditor’s report should include an emphasis of matter which describes the event and refers to a corresponding note to the financial statements when it is highly improbable that the entity will continue as a going concern because of an event occurring after the reporting date, even when the new information does not relate to conditions existing at reporting date and there has been adequate disclosure of this in the financial report.</p>

Matter	Issues for consideration
<i>True and Fair Override</i>	<p>Whether it is appropriate for the audit report to contain an emphasis of matter paragraph drawing attention to management's override of a statement of generally accepted accounting practice and the auditor's concurrence with that override, and if so, whether it should also be encouraged or even made mandatory?.</p> <p>In some financial reporting frameworks, it is permissible for management to depart from accounting standards where this is necessary to ensure that the financial statements give a true and fair view of, or present fairly, the financial position of the enterprise.</p> <p>Where a financial reporting framework has a true and fair override, the accounting standards are seen as methods to ensure that a true and fair view is shown, rather than as setting out the true and fair view. Thus the standards set out what would be the usual and expected accounting treatment, and departures are justified in cases where this treatment would not give a true and fair view. Where the entity has invoked the override, the auditor needs to consider whether the departure from accounting standards is justified and would modify the auditor's report appropriately (i.e., qualified or adverse as a result of a disagreement with management depending on the circumstances).</p> <p>As presently drafted, however, ISA 700 paragraphs 30–35 allow the use of an emphasis of matter paragraph, but do not explicitly mention a need to consider its use in this regard. The project would consider whether additional guidance, or the establishment of a new requirement, is considered appropriate in the circumstances when management invokes the True and Fair override (where permitted by the financial reporting framework).</p>
<i>Other examples</i>	<p>Whether other situations exist that should consider by the auditor for inclusion as a matter for emphasis paragraph, such as:</p> <ul style="list-style-type: none"> • When the entity is a component of a larger business enterprise. • When the entity has had significant transactions with related parties. • Unusually important subsequent events. • Accounting matters, other than those involving a change in accounting principles, affecting the comparability of the financial statements with those of the preceding period.
<i>Consistency in accounting principles and their application</i>	<p>Extant ISA 700 paragraph 27 states "An unqualified opinion also indicates implicitly that any changes in accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements". Existing guidance on modified reports, however, does not explicitly address the matter of consistency or provide any guidance regarding circumstances where consistency is not achieved and a requirement for disclosure of accounting change is absent in a financial reporting framework.</p>

Matter	Issues for consideration
<i>Consistency in accounting principles and their application (cont'd)</i>	<p>It is relevant to note that the U.S. ASB has established a Consistency Task Force to consider the issue of retaining its current guidance on reporting on consistency in the auditor's report and, in particular, whether discretionary changes in accounting policy would still be required to be reported upon. This review is being undertaken in part due to a perceived redundancy in communication of such matters given U.S. required accounting disclosures.</p> <p>The project will consider whether an emphasis of matter is appropriate if there has been a change in accounting principles, either through a mandated change or a discretionary change by management, or in the method of their application that has a material effect on the comparability of an entity's financial statements.</p>
<i>Reporting an emphasis of matter</i>	<p>Extant ISA 700 permits an emphasis of matter to be placed either before or after the audit opinion. Consistency in reporting affects users' ability to understand and evaluate the nature of modifications to the auditor's report. To achieve this and to reinforce the fact that an emphasis of matter does not affect the auditor's opinion on the financial report, the project will consider whether:</p> <ul style="list-style-type: none">• an emphasis of matter should always be placed immediately after the audit opinion paragraph.• a heading describing the nature of the emphasis of matter paragraph is beneficial. For example, when an inherent uncertainty exists, including an emphasis of matter section headed "Inherent uncertainty regarding ..."

Appendix B - Issues Pertaining to a Disagreement with Management

Matter	Issues for consideration
Acceptability of the accounting policies selected	<p>In determining whether the auditor has a disagreement with management for reporting purposes, many national standards use the term “appropriateness” of accounting principles and policies selected rather than simply their “acceptability”. Proposed ISA, <i>Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement</i> requires the auditor to consider the “appropriateness” of accounting policies. In addition, recent regulatory and other initiatives in the area of corporate governance have driven an expanded need for audit committees and auditors to comment on and evaluate the selection of accounting policies, not only for their acceptability but also their qualitative aspects and appropriateness. This principle may also be adopted when revising ISA 260, <i>Communication with Those Charged with Governance</i>. Issues to address include whether:</p> <ul style="list-style-type: none"> • the auditor should not only evaluate a disagreement with management based on the “acceptability of accounting policies selected” but on the “appropriateness” of the accounting policies; • to clarify the guidance that the accounting policies selected and applied should be in accordance with the entity’s financial reporting framework; • in assessing whether the accounting policies are appropriate and whether the financial statements are informative, the auditor should consider the consistency of presentation; • there is adequate disclosure of judgments made by management in applying the accounting policies that have the most significant effect on the amounts recognized in the financial statements.
Consistency in the application of accounting policies	<p>As noted in Appendix A, guidance in extant ISA 700 on modified reports does not explicitly address the matter of consistency or provide any guidance in circumstances where consistency is not achieved and requirements for disclosure or such accounting changes are absent in a financial reporting framework.</p> <p>In determining whether a disagreement with management may exist, the project will consider whether extant ISA 700 guidance should be expanded to explicitly address consistency in accounting principles or the method of application as a matter affecting the “acceptability” or “appropriateness” of accounting policies. That is, whether the auditor should be required to evaluate a change in accounting principle to satisfy himself that (a) the newly adopted accounting principle is a generally accepted accounting principle, (b) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, and (c) management’s justification for the change is reasonable.</p>

Matter	Issues for consideration
Estimates	<p>Whether additional guidance should be provided with respect to disagreements with management over estimates involving uncertainty and unreasonable estimates.</p> <p>Several other national standards emphasize the need to consider estimates in determining whether a disagreement with management exists. Issues in regards to reporting disagreements with management over estimates involving measurement uncertainty are also being highlighted by the Estimates Task Force.</p> <p>Guidance being developed by both the Estimates and Materiality Task Forces will be reviewed to see if additional wording arising from those projects might usefully be added.</p>
Additional considerations	<p>Whether other important factors should be considered in determining a disagreement with management and when forming an opinion, including whether</p> <ul style="list-style-type: none"> ▪ the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation; ▪ the information presented in the financial statements is classified and summarized in a reasonable manner, and ▪ the financial statements reflect the underlying transactions and events in a manner that presents fairly the financial position, financial performance, and cash flows of the entity.
Other ISA guidance	<p>Whether guidance on reporting in ISAs should be included either by way of cross reference or examples to consolidate and highlight the various situations that may involve a disagreement with management, including:</p> <ul style="list-style-type: none"> • ISA 240 - the existence of misstatements due to fraud or errors discovered that have a material effect on the financial statements and which have not been reflected or corrected in the financial statements; • ISA 250 - non-compliance with laws and regulations that has a material effect on the financial statements and which has not been properly reflected in the financial statements; • ISA 702 - When management does not amend the financial statements in circumstances where the auditor believes they need to be amended and the auditor's report has not been released to the entity, the auditor should express a qualified opinion or an adverse opinion; • ISA 400 - When the auditor determines that detection risk regarding a financial statement assertion for a material account balance or class of transactions cannot be reduced to an acceptably low level, the auditor should express a qualified opinion or a disclaimer of opinion; • ISA 510 - If the current period's accounting policies have not been consistently applied in relation to opening balances and if the change has not been properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion as appropriate.

Appendix C - Issues Pertaining to a Scope Limitation

Matter	Issues for consideration
<i>Determining a scope limitation</i>	<p>In addition to the issued identified in this regard in the project proposal, the follows issues would also be addressed. These include determining whether:</p> <ul style="list-style-type: none"> • it is necessary to strengthen the guidance as to what constitutes “desirable” in the context of obtaining sufficient appropriate audit evidence. This may strengthen the principles put forth regarding obtaining sufficient appropriate evidence or scope limitation in ISA 500, ISA 400, ISA 580, ISA 501, ISA 250, ISA 600, ISA 240, and ISA 550. • the auditor should disclaim an opinion on the financial statements when significant limits on the scope of the audit are imposed by the client. • ISA 700 provides adequate guidance in respect of situations where a scope limitation or uncertainties exist. <p>Some concern has been expressed by IAASB members regarding the clarity of this guidance. Clearly, circumstances with respect to contingencies and scope limitations are different. In both situations, the auditor is faced with a lack of information, but there is an important difference. For a contingency, the necessary information does not exist because it is dependent on the outcome of a future event. For a scope limitation, the necessary information should exist or have existed; however, it was not available to the auditor for his examination. The proposal would consider expanding the guidance in this area.</p>
<i>Auditor responsibility</i>	<p>Whether the current guidance pertaining to additional procedures should be established as a basic principle or essential procedure. That is, whether the following should constitute black letter guidance: “When a scope limitation is imposed by the circumstances of the particular engagement, the auditor should attempt to carry out reasonable alternative procedures to overcome the limitation.”</p>
<i>Other ISA guidance</i>	<p>Guidance on scope limitations exist in numerous ISAs as noted above. Consideration will be given as to whether guidance on reporting that exists in other ISAs should be included here, either by way of cross reference or examples, in order to consolidate and highlight the various situations that may involve a scope limitation.</p>

Appendix D - Issues Pertaining to a Qualified Opinion

Matter	Issues for consideration
<i>Determining the need for a Qualified Opinion and deciding between adverse and disclaimer opinions</i>	<p>Both qualitative and quantitative factors of materiality are important in making this decision. The project would consider whether guidance being proposed in the Materiality Project should be explained in the context of making a judgment on the form of modification. The following factors would be considered as guidance in making a judgment regarding materiality :</p> <ul style="list-style-type: none"> • The degree to which the matter impairs the usefulness of the financial statements; • The extent to which the effect of the matter on the financial statements can be determined; • The extent to which the effects on the financial statements can be related to specific items; • The significance of an item to a particular entity (for example, inventories to a manufacturing company; • The pervasiveness of the misstatement (such as whether it affects the amounts and presentation of numerous financial statement items); and • The effect of the misstatement on the financial statements taken as a whole.
<i>Intention of Qualification</i>	<p>ISA 700 .39 states “An adverse opinion should be expressed when the possible effects of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.”</p> <p>The current wording may be interpreted to permit an "except for" opinion if a matter that is material and pervasive does not render the financial report as a whole misleading when it is read in conjunction with the audit report.</p> <p>The proposal would address whether the current wording is appropriate and reflects best practice. As an alternative, an argument can be made that the audit report ought not be treated as part of the financial report and, therefore, ought not be used as a means of providing information to overcome deficiencies in the financial report. Therefore, this would require that the auditor's decision as to whether to issue an "except for" or adverse opinion be made by considering the effect of the matter on the financial report alone, rather than by considering its effect on the financial report when read in conjunction with the audit report.</p> <p>This is a fundamental issue requiring careful deliberation as it may affect the frequency and nature of modifications to the auditor's report.</p>

Matter	Issues for consideration
<i>Other considerations</i>	<p>A number of other national standards include basic principles or essential procedures surrounding circumstances where extant ISA 700 is silent. To enhance consistency and to provide appropriate guidance, this project would consider whether:</p> <ul style="list-style-type: none"> • The auditor should ensure that the explanatory material included in a qualification section or an emphasis of matter section is reliable and satisfies the test of materiality. • The auditor should not unreasonably defer issuing an audit report in the hope of obtaining further evidence to resolve a situation that may result in a modified audit report. • Before expressing a qualified opinion, the auditor should take all reasonable steps to be in a position to express an unqualified opinion. • If the effect on the financial statements of the matter causing the reservation is not reasonably determinable, the auditor should so state and explain the underlying reasons • When generally accepted accounting principles are considered appropriate and compliance with the requirements of regulatory legislation results in a departure from an ISA, whether a reservation of the auditor's opinion would be necessary.
<i>Reporting a qualified opinion</i>	<p>Extant ISA 700 encourages but does not require a consistent placement of qualification paragraphs. In addition, ISA 700 paragraph 40 requires quantification of the possible effects of a qualification "unless impracticable".</p> <p>To enhance consistency in reporting, the project will therefore consider whether:</p> <ul style="list-style-type: none"> • an imperative should be established that qualifications always are reported in a separate paragraph preceding the opinion or disclaimer of opinion. • matters subject to qualification should be quantified unless they are incapable of being measured reliably, and whether in such cases a statement to that effect and the related reasons should be disclosed in the audit report.

Appendix E - Other Matters for Consideration

Matter	Issues for consideration
<i>Special reporting responsibilities</i>	<p>There may be a need to address developments being considered by the Reporting Task Force in the revision of ISA 700 on unmodified reports. In particular, the manner in which the auditor reports on special reporting responsibilities is being reconsidered by the Reporting Task Force and IAASB. Depending on the outcome of these deliberations, the project may need to consider guidance that addresses the interrelationship between a modification relating to the auditor's opinion on the financial statements and the need for a modification to the auditor's opinion on a special reporting responsibility, and conversely as the circumstances require.</p> <p>These and related issues should be considered as revised ISA 700 is further developed.</p>
<i>Consistency among ISAs</i>	<p>The project would also have to review the guidance on modified reports in all ISAs to ensure that guidance is based on consistent principles and that the principles within ISA 701 are complete and provide the appropriate foundation.</p> <p>For example, ISA 510 provides the option of a qualified or disclaimed opinion regarding the results of operations, and unqualified opinion regarding financial position in those jurisdictions where it is permitted. Not consistent with view of f/s as a whole and allows alternatives.</p> <p>Views on the position that the IAASB believes is correct have to be clearly expressed in ISA 701 and alternatives eliminated, unless there is a substantive difference in circumstances.</p>
<i>Piecemeal opinion</i>	<p>Whether extant ISA 700 should explicitly prohibit piecemeal opinions.</p> <p>In some circumstances, the auditor may express an adverse opinion or disclaim an opinion on financial statements but may wish to include in the auditor's report a supplementary opinion that certain specific items within the financial statements were presented fairly in accordance with the relevant financial reporting framework. Such an opinion, which is described as a piecemeal opinion, tends to contradict or overshadow an adverse opinion or a disclaimer of opinion.</p> <p>The specific items not affected by the overall opinion may be more appropriately dealt with in a special engagement (see ISA 800, the Auditor's Report on Special Purpose Audit Engagements) or in a specified procedures engagement (see ISA 920, Engagements to Perform Agreed-Upon Procedures Regarding Financial Information).</p>
<i>Transitional provisions</i>	<p>Depending on the nature of the revisions to the guidance on modified reports, the introduction of new or revised basic principles or essential procedures may require a different form of auditor's report from that used in the prior year, even when the circumstances remain essentially unchanged from the prior year. Consideration will need to be given, if applicable, in addressing such circumstances.</p>

Comments by Technical Managers/Committee Secretaries

The comments of *each* Technical Manager are required before this Project Proposal is considered by the committee proposing to undertake the project.

Secretary to FMAC

CLASSIFICATION

Class: A

SUGGESTED PRIORITY

High.

OTHER COMMENTS

Signed Robin MathiesonDate April 21, 2003**Secretary to IAASB**

CLASSIFICATION

Class: A B1 B2 C

SUGGESTED PRIORITY

OTHER COMMENTS

Signed _____

Date _____

Secretary to Education

CLASSIFICATION

Class: A

SUGGESTED PRIORITY

High.

OTHER COMMENTS

Signed Claire EganDate April 22, 2003

Secretary to Ethics

CLASSIFICATION

Class: A

SUGGESTED PRIORITY

High.

OTHER COMMENTS

Signed Gill SpaulDate April 22, 2003**Secretary to Compliance**

CLASSIFICATION

Class: A

SUGGESTED PRIORITY

High.

OTHER COMMENTS

Signed Peter JohnstonDate April 15, 2003**Secretary to PSC**

CLASSIFICATION

Class: A B1 B2 C

SUGGESTED PRIORITY

OTHER COMMENTS

Signed _____

Date _____

Secretary to TAC

CLASSIFICATION

Class: A

SUGGESTED PRIORITY

High.

OTHER COMMENTS

The TAC has expressed significant interest in this project. The topic of auditor's reports has been frequently discussed by the Committee. The TAC would greatly appreciate the opportunity to provide input into this project.

Signed Russell GuthrieDate April 17, 2003

Secretary to SMP Task Force

CLASSIFICATION

Class: A

SUGGESTED PRIORITY

High.

OTHER COMMENTS

Signed Robin MathiesonDate April 21, 2003**Technical Director**

CLASSIFICATION

Class: A B1 B2 C

SUGGESTED PRIORITY

OTHER COMMENTS

Signed _____

Date _____