

Usage of Emphasis of Matter Paragraphs in the Auditor's Report – Discussion Paper

Introduction

In the issues paper for the April 2004 IAASB meeting, the ISA 701 Task Force proposed that ISA 701 continue to permit the auditor to emphasize other significant matters or unusual circumstances where the auditor determines such an emphasis is necessary. Restricting emphasis of matter (EOM) paragraphs only to those circumstances in which they were required by specific ISAs was not considered appropriate, first because this would require the IAASB to identify all possible circumstances and secondly, because it would seem contradictory to the principles-based/use of judgment approach in developing ISAs. The auditor's only means of communicating with readers of financial statements is the auditor's report covering those financial statements.

At the same meeting, another proposal to expand the requirements for emphasis of matter paragraphs was generally not supported by the IAASB, as doing so may widen the expectation gap. The IAASB agreed that EOM paragraphs should not be the norm; industries with inherent uncertainties and the use of the true and fair view override are not so unusual as to warrant further emphasis, the nature of uncertainties that are common to certain industries are generally understood by readers, and financial reporting frameworks that permit the override ordinarily contain disclosure requirements when the override has been invoked. In this regard, the IAASB agreed that: (a) the existing requirements for EOM paragraphs in proposed ISA 701 and other ISAs should be retained; and (b) although it may be difficult to articulate, EOM paragraphs should also be required if the auditor judges that it is necessary so that the reader is not misled by, or does not misunderstand, information in the financial statements.

At the June 2004 CAG meeting, the ISA 701 Task Force was asked to develop overarching principles that would help drive consistency in the usage of emphasis of matter paragraphs in auditor's reports. In response to these requests from CAG and the IAASB, the Task Force has considered the current requirements in the ISAs for use of EOM paragraphs and developed a proposal.

Objective

The objective of this discussion paper is to obtain IAASB views on the Task Force's proposals for the use of EOM paragraphs in auditor's reports.

Proposals

In reviewing the requirements in the extant ISAs and IAPSs for the use of EOM paragraphs, the ISA 701 Task Force identified the two following situations in which EOM paragraphs are used:

- (a) When an auditor decides that it is necessary to draw the reader's attention to a significant uncertainty disclosed in the financial statements (see Appendix 1).

- (b) When there is a risk of auditor association with misleading or incorrect information but that information is not covered by the auditor's report (see Appendix 2).

Proposal I

To drive consistency in the use of EOM paragraphs and to clarify to the reader of the auditor's report when EOM paragraphs relate to matters included in the financial statements and, as such, are covered by the auditor's opinion, the Task Force believes that the IAASB should limit the use of EOM paragraphs in auditor's reports to situations that meet the following three conditions:

- (a) Where a significant uncertainty exists but it is relatively unique to the entity (i.e., it is not an uncertainty common to most entities in the industry),
- (b) The uncertainty is disclosed in the financial statements, and
- (c) Where the auditor agrees with management on the accounting policy, the application of the accounting policy and the adequacy of related disclosures.

The Task Force proposes that the auditor should not be permitted to highlight matters, other than significant uncertainties reflected in the financial statements because the Task Force believes that a significant uncertainty is the only matter reflected in the financial statements to which it is necessary to draw the readers' attention. When the auditor wants to highlight other matters that are not reflected in the financial statements, these matters should not be discussed in an EOM paragraph. (See Proposal III)

Proposal II

If the IAASB supports the Task Force's first proposal, the Task Force then proposes that the heading "Significant uncertainty(ies)" be used for the EOM paragraph, which should follow the opinion paragraph in the auditor's report. As a result of this change in terminology, the Task Force would also propose the elimination of the term EOM paragraph from the ISAs and the IAPs.

Proposal III

In addition to emphasizing matters disclosed in the financial statements, the auditor may find it necessary to include in the auditor's report other issues because the auditor's report is the auditor's only means of communicating to parties outside the entity. Currently there are requirements in the ISAs for the auditor to include an EOM paragraph in the auditor's report other than those that relate to significant uncertainties: the primary purpose of these requirements is to avoid auditor association with misleading information that is not included in the financial statements. The auditor's report is the only means available to the auditor for communicating the fact that the auditor may be associated with misleading information. This other category of paragraph, which would be placed directly after the opinion paragraph, and would have the heading "Other Significant Matters, " would address matters such as: (1) avoidance of auditor association with misleading information, (2) other statutory requirements and (3) in rare and unusual circumstances other matters, that are not contained in the financial statements. For purposes of clarity, the Task Force proposes not to include these other items in the EOM category (i.e.,

significant uncertainties) because they do not emphasize a matter that is included in the financial statements.

The following table identifies requirements in the ISAs and IAPS for the use of EOM paragraphs.

- The first column identifies the ISA or IAPS and the paragraph containing each requirement.
- The next three columns of the table describe the Task Force's three proposed reasons for highlighting a matter in a paragraph following the opinion paragraph in the auditor's report: (1) significant uncertainty (2) avoidance of auditor association with misleading information and (3) statutory requirements.
- The last column of the table indicates those ISA and IAPS requirements for EOM that do not fit into the Task Force's proposal

The full text of each ISA or IAPS requirements is contained in the three Appendices at the end of this discussion paper.

Extant ISA and IAPS Requirements for EOM Paragraphs

ISA or IAPS requirement for EOM	Fits proposed category 1: Significant uncertainty	Fits proposed category 2: Avoid Assoc. w/Misleading information	Fits proposed category 3: Statutory requirements	Does not fit TF proposal
ISA 570.33	√	---	---	---
ISA 700.32	√	---	---	---
ISA 560.16	---	√	---	---
ISA 710.13	---	---	---	√
ISA 710.24	---	---	---	√
ISA 710.25	---	---	---	√
ISA 720.13	---	√	---	---
IAPS 1006	---	√	√	---
IAPS 1014	---	√	√	---
Proposed ISA 700 - Sept. 2004 Draft (See Appendix 3)				
ISA 700.06(b)	---	√	√	---
ISA 700.43	---	---	√	---
ISA 700.FN 9	---	---	---	√
ISA 700.54	---	---	√	---

ISA or IAPS requirement for EOM	Fits proposed category 1: Significant uncertainty	Fits proposed category 2: Avoid Assoc. w/Misleading information	Fits proposed category 3: Statutory requirements	Does not fit TF proposal
ISA 200.42	---	---	√	---
ISA 200.46 b	---	---	√	---
ISA 200.47	---	---	√	---
ISA 210.13	---	---	√	---
ISA 210.18	---	---	√	---

If IAASB supports the Task Force’s proposals the Task Force recommends that the IAASB eliminate the requirements for EOM paragraphs in ISA 710 as a conforming change. The Task Force also proposes making conforming changes to the language in ISAs 560, 570, 720 and IAPSS 1006 and 1014.

IV. Advantages and Disadvantages of the Proposals

Advantages

The Task Force’s proposals provide an overarching principle for the use of EOM paragraphs in the auditor’s report. In doing so, the Task Force provides more explicit guidance to auditors for the use of such paragraphs and would be responsive to the CAG’s request.

The Task Force believes that the use of an explicit heading for such paragraphs (i.e., “Significant Uncertainties”) will provide more effective communication with readers of auditor’s reports. The task force further believes that the use of explicit headings for other matters discussed in paragraphs that follow the opinion paragraphs, such as (1) other significant matters and (2) statutory responsibilities, will also communicate more effectively with readers of auditor’s reports.

Disadvantages

An auditor’s report may get very unwieldy if it contains: (1) an EOM paragraph with the heading “Significant Uncertainties” that describes one or more significant uncertainties, (2) another paragraph headed “Other Significant Matters” that describes instances of misleading information in documents containing audited financial statements, and (3) a third paragraph with the heading “Statutory Responsibilities” that describes additional statutory responsibilities that the auditor has in a particular jurisdiction. Further, it is conceivable that there could be multiple paragraphs describing significant uncertainties and other significant matters, thus making the report both lengthy and cumbersome. Yet such a report could still be an unqualified auditor’s report.

The Task Force believes that its proposals cover the new circumstances for EOM paragraphs identified by the ISA 700 Task Force as described in the table above.

APPENDIX 1**Current Requirements in the ISAs for EOM Paragraphs Relating to Significant Uncertainties**

Here are the requirements in the ISA for EOM paragraphs that relate to significant uncertainties:

ISA 570, *Going Concern*

The lead-in to paragraph 33 of ISA 570 assumes that the auditor has concluded (1) that use of the going concern assumption by the entity is appropriate and (2) that a material uncertainty exists related to events or conditions that alone or in the aggregate may cast significant doubt on the entity's ability to continue as a going concern.

Paragraph 33: If adequate disclosure is made in the financial statements, the auditor should express an unqualified opinion but modify the auditor's report by adding an emphasis of matter paragraph that highlights the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern and draws attention to the note in the financial statements that discloses the matters set out in paragraph 32 of ISA 570, *Going Concern*.

ISA 700.32

The auditor should consider modifying the auditor's report by adding a paragraph if 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.

APPENDIX 2

Current Requirements in the ISAs for EOM Paragraphs for Matters Other than Significant Uncertainties

There are other matters that may require emphasis in the auditor's report but the purpose of this guidance is to avoid auditor association with misleading information:

ISA 560, Subsequent Events

Facts Discovered After the Financial Statements Have Been Issued

14. When, after the financial statements have been issued, the auditor becomes aware of a fact which existed at the date of the auditor's report and which, if known at that date, may have caused the auditor to modify the auditor's report, the auditor should consider whether the financial statements need revision, should discuss the matter with management, and should take the action appropriate in the circumstances.

15. When management revises the financial statements, the auditor would carry out the audit procedures necessary in the circumstances, would review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation, and would issue a new report on the revised financial statements.

16. The new auditor's report should include an emphasis of a matter paragraph referring to a note to the financial statements that more extensively discusses the reason for the revision of the previously issued financial statements and to the earlier report issued by the auditor. The new auditor's report would be dated not earlier than the date the revised financial statements are approved and, accordingly, the procedures referred to in paragraphs 4 and 5 would ordinarily be extended to the date of the new auditor's report.

ISA 710, Comparatives

Paragraph 13: When the auditor's report on the prior period, as previously issued, included a qualified opinion, disclaimer of opinion, or adverse opinion and the matter which gave rise to the modification is resolved and properly dealt with in the financial statements, the current report does not ordinarily refer to the previous modification. However, if the matter is material to the current period, the auditor may include an emphasis of matter paragraph dealing with the situation.

Paragraph 24: **When the comparatives are presented as comparative financial statements, the auditor should issue a report in which the comparatives are specifically identified because the audit opinion is expressed individually on the financial statements of each period presented.** *Since the auditor's report*

on comparative financial statements applies to the individual financial statements presented, the auditor may express a qualified or adverse opinion, disclaim an opinion, or include an emphasis of matter paragraph with respect to one or more financial statements for one or more periods, while issuing a different report on the other financial statements.

Paragraph 25: When reporting on the prior period financial statements in connection with the current year's audit, if the opinion on such prior period financial statements is different from the opinion previously expressed, the auditor should disclose the substantive reasons for the different opinion in an emphasis of matter paragraph. This may arise when the auditor becomes aware of circumstances or events that materially affect the financial statements of a prior period during the course of the audit of the current period.

ISA 720, Other Information in Documents Containing Audited Financial Statements

The purpose of ISA 720 is to provide guidance on the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements. **The auditor should read the other information to identify material inconsistencies with the audited financial statements.**

In issuing such a document (annual report), an entity may also include, either by law or custom, other financial and non-financial information. For purposes of ISA 720, such other financial and non-financial information is called "other information."

If, on reading the other information, the auditor identifies a material inconsistency, the auditor should determine whether the audited financial statements or the other information needs to be amended.

Paragraph 13: If an amendment is necessary in the other information and the entity refuses to make the amendment, the auditor should consider including in the auditor's report an emphasis of matter paragraph describing the material inconsistency or taking other actions.

IAPS 1006, Audits of the Financial Statements of Banks

102. The financial statements of banks are prepared in the context of the legal and regulatory requirements prevailing in different countries, and accounting policies are influenced by such regulations. In some countries the financial reporting framework for banks (the banking framework) differs materially from the financial reporting framework for other entities (the general framework). When the bank is required to prepare a single set of financial statements that

comply with both frameworks, the auditor may express a totally unqualified opinion only if the financial statements have been prepared in accordance with both frameworks. If the financial statements are in accordance with only one of the frameworks, the auditor expresses an unqualified opinion in respect of compliance with that framework and a qualified or adverse opinion in respect of compliance with the other framework. When the bank is required to comply with the banking framework instead of the general framework, the auditor considers the need to refer to this fact in an emphasis of matter paragraph.

IAPS 1014, Reporting by Auditors on Compliance with International Financial Reporting Standards

11. A note to the financial statements containing disclosure about compliance with IFRSs may not contain misleading information such that the financial statements fail to comply with the national financial reporting framework. If the auditor is of the opinion that a reference to compliance with IFRSs is not misleading, the auditor may express an unqualified opinion on compliance with the national financial reporting framework. In certain circumstances, the auditor may decide to modify the auditor's report by adding an emphasis of matter paragraph to highlight the note that references compliance with IFRSs.⁴ The use of an emphasis of matter paragraph is not a substitute for issuing a qualified opinion or adverse opinion on compliance with the national financial reporting framework when disclosures as to compliance with IFRSs are misleading such that the financial statements fail to comply with the national financial reporting framework.

⁴ Paragraphs 30-35 of ISA 700 provide additional guidance on the use of an emphasis of matter paragraph.

APPENDIX 3**References to ISA 701 in ISA 700 Exposure Draft (ISAs 700, ISA 200, ISA 210 and ISA 560)****PROPOSED AMENDMENT TO INTERNATIONAL STANDARD ON
AUDITING 700**

2. [Note: This paragraph has been moved from paragraph 3 of the Exposure Draft, but is otherwise unchanged.] This ISA addresses circumstances when the auditor is able to express an unqualified opinion and no modification to the auditor's report is necessary. ISA 701, "Modifications to the Independent Auditor's Report" establishes standards and guidance on the modifications to this report for an emphasis of matter, a qualified opinion, a disclaimer of opinion, or an adverse opinion.

- 6b. When wording prescribed by law or regulation differs significantly from the phrases in paragraph 6, the auditor carefully considers whether there may be a risk that users might misunderstand the assurance obtained in an audit of financial statements. For example, the wording might convey to readers that the auditor is attesting to the accuracy of the financial statement amounts rather than expressing an opinion on whether the financial statements give a true and fair view or are presented fairly, in all material respects. In such circumstances, the auditor considers whether the risk of misunderstanding can be mitigated through appropriate explanation in an emphasis of matter paragraph (ISA 701, "Modifications to the Independent Auditor's Report").

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

10. ~~The auditor makes these judgments by considering the entity's compliance with specific requirements of the financial reporting framework and the fair presentation of the financial statements as a whole. In some circumstances, failure to disclose relevant information not specifically contemplated by the financial reporting framework, or i~~ In extremely rare circumstances, compliance with a specific requirement in the framework itself, may result in financial statements that are so misleading, that they fail to give a true and fair view of (or present fairly, in all material respects) for example, in the case of financial statements prepared in accordance with International Financial Reporting Standards (IFRS), the financial position, financial performance or cash flows of the entity. In these circumstances, the auditor discusses with management its responsibilities under the financial reporting framework. Some Most acceptable financial reporting frameworks for general purpose financial statements acknowledge, implicitly or explicitly, that there are may be circumstances when it is necessary for the financial statements to disclose information not specifically contemplated by the financial reporting framework, or 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. Those financial

~~reporting frameworks often and~~ provide guidance on the disclosures required ~~in such circumstances~~. Other financial reporting frameworks, ~~however~~, may not provide any guidance on these circumstances. If the auditor encounters circumstances that leads the auditor to conclude that compliance with a specific requirement results in financial statements that are misleading, irrespective of the requirements of the financial reporting framework, the auditor discusses the matter with management and considers the need to modify the auditor's report. The modifications, if any, that are appropriate to the auditor's report which will depend on how management has addressed ~~addresses~~ the matter in the financial statements and how the financial reporting framework deals with these rare circumstances (see ISA 701, "Modifications to the Independent Auditor's Report").

43. ~~[REMOVED FROM THIS PARAGRAPH] This is ordinarily achieved by The auditor addresses~~ addressing these other reporting responsibilities in a separate section of the report in order to clearly distinguish them from the auditor's responsibilities for, and opinion on, the financial statements. that follows the opinion paragraph, and when applicable, any emphasis of matter paragraph on the financial statements.

Other Reporting Responsibilities [Footnote: ¹ In addition to other reporting responsibilities, relevant standards, laws or generally accepted practice in a jurisdiction may require or permit the auditor to elaborate on matters relevant to the auditor's report on the financial statements. Such matters may be addressed in an emphasis of matter paragraph, as discussed in ISA 701, "Modifications]

54. The auditor may refer to the audit having been conducted in accordance with both ISAs as well as national auditing standards when the auditor complies with each of the ISAs relevant to the audit and performs any additional audit procedures necessary to comply with the relevant standards of that jurisdiction. A reference to both the ISAs and national auditing standards is not appropriate if there is a conflict between the reporting requirements regarding the auditor's report in of the ISAs and in national auditing standards that affects the auditor's opinion or the need to include an emphasis of matter paragraph in the particular circumstances. For example, some national auditing standards prohibit the auditor from including an emphasis of matter paragraph to highlight a going concern problem, whereas ISA 701, requires the auditor to modify the auditor's report by adding an emphasis of matter paragraph in such circumstances. In case of such conflicts, the auditor's report refers only to the auditing standards (either ISAs or the relevant national auditing standards) in accordance with which the auditor has complied with the reporting requirements.

PROPOSED AMENDMENT TO INTERNATIONAL STANDARD ON AUDITING 200

42. In some jurisdictions, legislative and regulatory requirements ~~also may~~ supplement ~~the a identified applicable~~ financial reporting framework adopted by management with additional requirements relating to the preparation and presentation of financial statements. In these jurisdictions, the applicable financial reporting framework, for the purposes of applying the ISAs, encompasses both the identified financial reporting framework and such additional requirements, provided they do not conflict with the applicable financial reporting framework. This may, for example, be the case when additional requirements prescribe disclosures in addition to those required by the identified financial reporting framework or when they narrow the range of acceptable choices that can be made within the identified financial reporting framework. If the additional requirements conflict with the applicable financial reporting framework, the auditor discusses the nature of the requirements with management and whether the additional requirements can be met through additional ~~they can be addressed in the notes to the financial statements as supplementary disclosures.~~ Alternatively, the auditor considers whether it is necessary to modify the report, see ISA 701, “Modifications to the Auditor’s Report”.
- 46b. When the auditor concludes that the financial reporting framework adopted by management is not acceptable, the auditor considers the implications in relation to engagement acceptance (ISA 210) and the auditor’s report (ISA 701, “Modifications to the Independent Auditor’s Report”).

Expressing an Opinion on the Financial Statements

47. When the auditor is expressing an opinion on a complete set of general purpose financial statements, as defined by the applicable financial reporting framework, the auditor refers to ISA 700, “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements,” for guidance on the matters the auditor considers in forming an opinion on such financial statements and on the form and content of the auditor’s report. The auditor also refers to ISA 701, “Modifications to the Auditor’s Report”, when expressing a modified audit opinion, including an emphasis of matter, a qualified opinion, a disclaimer of opinion or an adverse opinion.

PROPOSED AMENDMENT TO INTERNATIONAL STANDARD ON AUDITING 210

13. Without an acceptable financial reporting framework management does not have an appropriate ~~has no~~ basis for preparing the financial statements and the auditor does not have suitable criteria for evaluating the entity’s financial statements. In these circumstances, the auditor encourages management to address the deficiencies in

the financial reporting framework or to ~~identify~~ adopt another financial reporting framework that is acceptable. When the financial reporting framework is required by law or regulation and management has no choice but to adopt this framework, the auditor accepts the engagement only if the deficiencies can be adequately explained to avoid misleading users, see ISA 701, “Modifications in the Auditor’s Report”, paragraph 10. ISA 200.37 to 46a describes the factors the auditor considers in determining whether the financial reporting framework adopted by management is acceptable.

18. When the auditor accepts an engagement involving an applicable financial reporting framework that is not established by an organizations that is are an authorized or recognized regulatory body or international or national to promulgate standards for general purpose financial statements of certain types of entities setting organization, the auditor may encounter deficiencies in that framework that were not anticipated when the engagement was initially accepted and that indicate that the framework is not acceptable for general purpose financial statements. In these circumstances, the auditor discusses the deficiencies with management and the ways in which such deficiencies may be addressed. If the deficiencies result in financial statements that are misleading and there is agreement that and the need for management will to adopt another financial reporting framework that is acceptable then suitable. As ~~discussed in paragraph 20,~~ the auditor ~~also~~ refers to the change in the financial reporting framework in a new engagement letter. If management refuses to adopt another financial reporting framework, the auditor considers the impact of the deficiencies on the auditor’s report, see ISA 701, “Modifications to the Auditor’s Report”.

PROPOSED AMENDMENT TO INTERNATIONAL STANDARD ON AUDITING 560

12. **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, as described in ISA 701, “Modifications to the Independent Auditor’s Report.”**