

DRAFT EXPLANATORY MEMORANDUM**ISA 701 and ISA 702 Exposure Drafts
February 2005****Introduction**

This memorandum provides some background to, and an explanation of, the proposed revised International Standard on Auditing (ISA) 701, under the new title of “Modifications to the Opinion in the Independent Auditor’s Report,” and ISA 702, “Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor’s Report,” approved for issuance by the International Auditing and Assurance Standards Board (IAASB) in March 2005.

Background

In revising extant ISA 700, “The Auditor’s Report on Financial Statements,” the IAASB took a two-stage approach, splitting the guidance in extant ISA 700 into two ISAs:

- ISA 700. The scope of this ISA was restricted to the auditor’s report when the auditor is able to express an unmodified opinion and no modification of the auditor’s report is necessary. ISA 700 (Revised), “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements,” was issued in December 2004 and is effective for auditor’s reports issued on or after December 31, 2006.
- ISA 701. The standards and guidance in extant ISA 700 on modifications to the auditor’s report were moved to new ISA 701.

Objectives of the ISA 701 Project

The IAASB’s objectives in revising the guidance in ISA 701 on modifications to the auditor’s report 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 prescriptive 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.

Significant Proposals**Terminology: “Modified Opinion” vs. “Modified Report”**

The IAASB’s objectives in revising ISA 701 include improving the understandability and enhancing the relevance and usefulness of ISA 701. The term “modified” is not sufficiently clear to allow practitioners to be able to distinguish between matters that affect the auditor’s opinion on the financial statements and those that do not. ISA 701’s use of the word “modified” to mean

both modifications to the auditor's opinion and the inclusion of emphasis of matter paragraphs in the auditor's report may be causing confusion among practitioners. Also, countries that translate the ISAs have found it very difficult to explain the difference between a qualification to the opinion and a modification to the auditor's report. Thus the IAASB decide to limit the use of the term "modification" to "modifications to the opinion in the auditor's report;" the ISAs will no longer use the term "modified report."

Terminology: "Modifications to the Opinion" and "Modified Opinions" vs. "Qualifications to the Opinion" and "Qualified Opinions"

In developing the proposed guidance contained in this exposure draft, members of the IAASB ultimately took the view that neither disclaimers of opinion nor adverse opinions can be described as qualified opinions; such opinions are not qualified in any way. Thus the exposure draft uses the term "modifications to the opinion in the auditor's report" to describe "except for opinions," "adverse opinions," and "disclaimers of opinion." Further, when an auditor concludes that an unmodified opinion cannot be expressed but the effect of any disagreement with management, or limitation on scope, is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion, the auditor expresses an "except for opinion;" this type of opinion was formerly referred to as a "qualified opinion," but that term will no longer be used in the ISAs.

Split Between ISA 701 and ISA 702

In developing guidance on modifications to the independent auditor's report (ISA 701), the IAASB decided to split the guidance as follows:

- ISA 701, "Modifications to the Opinion in the Independent Auditor's Report."
- ISA 702, "Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report."

The IAASB took the view that the split between ISA 701 and ISA 702 would help clarify the difference between the following:

- An auditor's report with a modified opinion is one that contains an "except for opinion," an "adverse opinion" or a "disclaimer of opinion" on the financial statements because of (1) a disagreement with management or (2) an inability to obtain sufficient appropriate audit evidence. (ISA 701)
- An auditor's report that contains an emphasis of matter paragraph or an other matters paragraph (ISA 702); inclusion of such a paragraph does not give rise to a modification to the auditor's opinion.

The IAASB concluded that auditors would be far less likely to confuse or unnecessarily link the requirements for emphasis of matter paragraphs or other matters paragraphs with modifications to the auditor's opinion if the guidance on those two topics is contained in separate ISAs.

ISA 701, “MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR’S REPORT”

This ISA establishes standards and provides guidance on (a) circumstances that may result in a modification of the auditor’s opinion on the financial statements, (b) the type of opinion appropriate in the circumstances, and (c) the content of the auditor’s report when the auditor’s opinion is modified. The standards and guidance in this ISA apply to auditor reports issued in accordance with ISA 700 (Revised), proposed ISA 800 (Revised) and proposed ISA 701 (Revised).

CIRCUMSTANCES RESULTING IN A MODIFICATION TO THE AUDITOR’S OPINION

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 and accordingly are not prepared, in all material respects, in accordance with an applicable financial reporting framework; or
- b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements are free from material misstatement.

The auditor expresses a modified opinion in the auditor’s report on the financial statements when:

- a) The auditor concludes that, based on the audit evidence obtained, the financial statements are not free from material misstatement due to a disagreement with management about (i) the acceptability of selected accounting policies, (ii) the application of the selected accounting policies, or (iii) the adequacy of disclosures in the financial statements;
- b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements are free from material misstatement (also referred to as a limitation on the scope of the audit).

This ISA establishes three types of modified opinions, an *except for opinion*, an *adverse opinion*, and a *disclaimer of opinion*, the choice of which will depend upon the materiality and pervasiveness of the matter giving rise to the modification:

- a) The auditor expresses an *except for opinion* when the auditor concludes that the effect of any disagreement with management while material, is not pervasive; therefore the financial statements taken as a whole are not misleading and thus do not require an adverse opinion.
- b) The auditor expresses an *adverse opinion* when the auditor concludes that the effect of a disagreement with management is material and pervasive to the financial statements such that an except for opinion is not adequate to disclose the misleading nature of the financial statements.
- c) The auditor expresses an *except for opinion* when the auditor concludes that the possible effect of any inability to obtain sufficient appropriate audit evidence, while material, could not be pervasive; therefore the financial statements taken as a whole are not misleading and therefore do not require a *disclaimer of opinion*.

- d) The auditor expresses a *disclaimer of opinion* when the possible effect of an inability to obtain sufficient appropriate audit evidence is material and pervasive to the financial statements such that the auditor is unable to express an opinion on the financial statements.

Materiality and Pervasiveness of the Matter Giving Rise to the Modification to the Auditor's Opinion

In deciding on the type of opinion, the auditor considers the materiality and pervasiveness of the matter giving rise to the modification to the auditor's opinion.

ISA 320 discusses the factors the auditor considers in determining the materiality of a matter and the importance of considering not only the financial magnitude but also the qualitative aspects of the matter. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other identified misstatements, even if they are of a lower level than the auditor had determined to be material when establishing the overall audit strategy. Circumstances that may affect the evaluation include, for example, the extent to which the misstatement affects compliance with regulatory requirements and debt covenants, or other contractual requirements.

In determining the pervasiveness of the effect of the disagreement with management or the inability to obtain sufficient appropriate audit evidence, the auditor considers the following:

- a) The degree to which the disagreement with management or inability to obtain sufficient appropriate audit evidence impairs the usefulness of the financial statements.
- b) The extent to which the disagreement with management or inability to obtain sufficient appropriate audit evidence can be (i) related to specific items in the financial statements and (ii) quantified.
- c) Whether the effect of the disagreement with management on the financial statements can be clearly described in the auditor's report so that the modification can address the incomplete or misleading nature of the financial statements.

The effect of a disagreement with management would ordinarily be considered to be pervasive when it affects the amounts and presentation of numerous financial statement items.

FORMAT AND CONTENT OF THE AUDITOR'S REPORT WHEN THE OPINION IS MODIFIED

Consistency in the auditor's report helps to promote the reader's understanding and to identify unusual circumstances when they occur. Although uniformity in the wording of a modified opinion and in the description of the basis for the modification may not be possible, consistency in both the form and content of the auditor's report is desirable. This ISA provides guidance on the format and content of such reports, including headings to be used within the report. It also provides illustrative auditor reports in the Appendix to the ISA; those reports are based on the form and content of the auditor's report on a complete set of general purpose financial statements.

ISA 702, “EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTERS PARAGRAPHS IN THE AUDITOR’S REPORT”

OBJECTIVE

Extant ISA 701 permits the auditor to modify the auditor’s report by including a paragraph to emphasize a matter without affecting the auditor’s opinion. The ISAs contain requirements for specific matters to be reported and ISA 701 also permits an emphasis of matter for other matters including those that do not affect the financial statements.

The IAASB’s objective is to clarify the requirements for matters to be emphasized in the auditor’s report; such guidance should help promote consistency in the application of emphasis of matter requirements.

ISA 702 establishes standards and provides guidance on circumstances when the auditor considers including an *emphasis of matter paragraph* or an *other matters paragraph* in the auditor’s report on the financial statements, and on the form and placement of such paragraphs. This guidance is applicable to auditor reports issued in accordance with ISA 700 (Revised), ISA 701 (Revised) and ISA 800 (Revised).

HOW “EMPHASIS OF MATTER PARAGRAPHS” DIFFER FROM “OTHER MATTERS PARAGRAPHS”

Under this proposal, the auditor may include in an emphasis of matter paragraph only matters that are required to be presented or disclosed in the financial statements or the notes thereto. The auditor may include other matters, which are not required to be presented or disclosed in the financial statements or notes thereto, in an “other matters paragraph” to follow the opinion paragraph in the independent auditor’s report.

EMPHASIS OF MATTER PARAGRAPHS

Overarching Principle for the Use of Emphasis of Matter Paragraphs in the Auditor’s Report

The overarching principle is that the auditor should consider emphasizing in the auditor’s report a matter in the financial statements when both of the following conditions are met:

- a) The matter is of fundamental importance to the user’s understanding of the true and fair view of the financial statements.
- b) The matter is unusual.

Ordinarily the auditor determines a matter to be of *fundamental importance* to the user’s understanding of the financial statements if the possible consequences of the matter could significantly affect the financial position, financial performance and cash flows.

The auditor ordinarily considers a matter to be *unusual* if it occurs infrequently or is out of the ordinary course of business.

The inclusion of an *emphasis of matter paragraph* in the auditor’s report does not affect the auditor’s opinion. It is not a substitute for the auditor’s expression of an except for opinion, an adverse opinion, or a disclaimer of opinion when required by the circumstances of a specific audit engagement [see proposed ISA 701 (Revised)] nor is it a substitute for disclosures that

management is required to make in the financial statements by the applicable financial reporting framework.

Accordingly, the auditor only includes an *emphasis of matter paragraph* in the auditor's report if the matter under consideration meets the following criteria:

- a) The matter is presented and disclosed in the entity's financial statements in accordance with the applicable financial reporting framework; and
- b) The auditor agrees with management on the selected accounting policy, its application and the presentation and disclosure of the matter.

When the matter under consideration does not meet these criteria, the auditor considers whether it represents a disagreement with management and whether an except for opinion or an adverse opinion is appropriate [see ISA 701(Revised)].

Circumstances in which the auditor may consider it necessary to include an *emphasis of matter paragraph*, when the criteria above are met, include the following:

- Significant uncertainties, other than those related to the use of the going concern assumption, such as an uncertainty related to the future outcome of major litigation or regulatory action (e.g., a regulatory agency requires a company to recall a major product for safety reasons);
- Significant and unusual related party transactions.
- Early application of a new accounting principle (or International Financial Reporting Standard) (i.e., before its application is required).
- A subsequent event disclosed in the financial statements.
- A matter such as a major catastrophe, which is disclosed in a note to the financial statements, that has had, or continues to have, a significant effect on the entity's business or operations.

OTHER MATTERS PARAGRAPHS

In some jurisdictions, the auditor's report may be the auditor's only means of communicating to users of the financial statements. As a result, the auditor may find it necessary to communicate matters in the auditor's report other than those described in the emphasis of matter guidance. Such other matters are not required to be in the financial statements and therefore are different from the matters that are referred to in an *emphasis of matter paragraph*.

Overarching Principle for the Use of Other Matters Paragraphs in the Auditor's Report

The auditor should include other matters in a separate paragraph of the auditor's report under the heading "Other Matters." This *other matters paragraph* ordinarily follows the auditor's opinion and any emphasis of matter paragraph.

The content of the *other matters paragraph* makes it clear to the users of the financial statements that such other matters are not included in the financial statements.

The *other matters paragraph* addresses matters that are not required to be recognized or disclosed in the financial statements by the applicable financial reporting framework. These would include the following:

- a) Avoidance of auditor association with misleading information in a document containing audited financial statements.
- b) Matters relating to the auditor's responsibility that are required or permitted to be communicated by standards, laws or generally accepted practice in a jurisdiction.
- c) In rare and unusual circumstances, other matters that the auditor considers relevant to communicate to the user.

Effective Date

The IAASB recommends that the proposed new ISA 701 and ISA 702 take effect for reports issued on or after December 31, 2006. This proposed effective date is consistent with the effective date of ISA 700 (Revised).

Guide for Commentators

The IAASB welcomes comments on the proposed revised ISA 701 and proposed new ISA 702. The IAASB is seeking comments on all aspects of the exposure draft. Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make explicit suggestions for any proposed changes in wording. When a respondent agrees with proposals in the exposure draft (especially those calling for changes in current practice), it will be helpful for the IAASB to be made aware of this view.

Special Considerations in the Audits of Small Entities

Respondents are asked to comment on whether, in their opinion, considerations in the audit of small entities have been dealt with appropriately in the proposed revised ISA 701 and proposed new ISA 702. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

Translations

Recognizing that many respondents intend to translate the proposed revised ISA 701 and the proposed new ISA 702 for adoption in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing this exposure draft.

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