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Agenda Item

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Committee: IAASB

Meeting Location: Warsaw

Meeting Date: July 9–13, 2007

Modifications

Objective of Agenda Item

To review the final wording changes to the revised drafts of the proposed ISA 705 (Revised and Redrafted), "Modifications to the Opinion in the Independent Auditor's Report", and the proposed ISA 706 (Revised and Redrafted), "Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor's Report," and to approve the redrafted ISAs for exposure.

Task Force Composition

The members of the redrafting task force are:

- Jan Bo Hansen (Chair, IAASB Member)
- Sylvia Smith (IAASB Technical Advisor)

Activities Since Last IAASB Discussions

The IAASB discussed the first drafts of the proposed ISAs 705 (Revised and Redrafted) and 706 (Revised and Redrafted) in February 2007. The task force did not meet formally but has considered the IAASB's comments in finalizing the wording changes now being presented. To ensure consistency of wording with the proposed ISA 700 (Redrafted), the task force has also considered the final changes the ISA 700 task force is proposing to the revised draft of that ISA.

Matters for IAASB's Consideration

1. ELEVATION OF THE DESCRIPTION OF PERVASIVENESS INTO A DEFINITION IN ISA 705

At the February 2007 meeting, it was suggested that because the term "pervasiveness" is so fundamental to a proper understanding of ISA 705, the task force should consider establishing a definition of the term in the clarified ISA based on guidance describing its meaning in the application material.

The task force notes that the IAASB had considered this matter previously in finalizing the close-off version of ISA 705, as a number of respondents to the exposure draft of the revised ISA 705 had suggested that a definition of pervasiveness should be provided, both in the ISA and in the Glossary of Terms. In closing off the revised ISA 705, the IAASB had accepted the task force's recommendation that a definition not be established on the ground that the evaluation of whether a matter is pervasive inherently called for the application of professional judgment.

However, in light of the clarification now being effected on the ISA and given the fact that the term is fundamental to a proper understanding of the requirements of the ISA, the task force proposes that a definition be established in the redrafted ISA based on wording used in the application material, notwithstanding the need for judgment to be applied in the circumstances (see paragraph 8). This would have the benefit of giving much more prominence to the meaning of pervasiveness in the ISA, commensurate with the importance of the term to the ISA, and bringing forward much earlier in the document the actual text explaining its meaning. The task force also believes that a definition would be appropriate because a consideration of the pervasiveness of misstatements (or other matters that could give rise to a modification) permeates the whole audit and is not limited to small aspect of it.

- ***Does the IAASB agree to elevate the description of pervasiveness into a definition?***

2. SCOPE LIMITATION IMPOSED BY MANAGEMENT (ISA 705)

At the February 2007 meeting, it was noted that the steps required of the auditor to address a scope limitation imposed by management seemed to be out of logical sequence. It was suggested that if the auditor were to become aware of such a limitation after engagement acceptance, the auditor should first turn to alternative procedures *before* requesting management to remove the limitation and communicating the matter to those charged with governance if that request is denied (rather than the other way round as established in the closed-off ISA 705).

The task force did not agree that this would result in a better outcome. From a practical point of view, the task force agreed that if management were to impose a limitation, it would be simpler and more effective for the auditor to first ask for the removal of the limitation before considering alternative procedures. If management (at the appropriate level) agrees, the auditor would avoid performing what might potentially be expensive alternative procedures. If management refuses the auditor's request, it would then only be right for the auditor to consider alternative procedures and communicate the issue with those charged with governance.

In addition, with the suggested reordering of the sequence, the requirement to communicate the scope limitation to those charged with governance would apply only after the auditor had performed alternative procedures and did not obtain the necessary audit evidence, and management further denied the auditor's request to remove the limitation. Consequently, were the auditor to successfully perform the alternative procedures, the auditor would not need to request management to remove the limitation, and in the absence of such a request being made, there would be no need to communicate the scope limitation to those charged with governance. The task force agreed that this would not be the right outcome because a scope limitation that management refuses to remove should be a matter worthy of the attention of those charged with governance even if the auditor were able to successfully perform alternative procedures. Not doing so would deny those charged with governance of knowledge of a significant matter of which the auditor is aware. Accordingly, the task force proposes that no change be made to the sequence of steps established in the closed-off ISA. (As agreed at the February 2007 meeting, however, the task force has simplified the structure of the original paragraph in the closed-off ISA into three shorter paragraphs – see paragraphs 13-15).

- ***Does the IAASB agree with the task force's proposal?***

3. EMPHASIS OF A MATTER "INCLUDED" IN THE FINANCIAL STATEMENTS (ISA 706)

At the February 2007 meeting, it was noted that in relation to the description of the nature of an emphasis of matter (EOM), the wording "the auditor may consider a matter *disclosed* in the financial statements to be of such importance to users' understanding of the financial statements…" could be interpreted literally to mean only matters that are disclosed in the financial statements and not matters that are recognized in the financial statements. It was suggested that a term such as "included" might be more inclusive than "disclosed."

The task force agreed that this wording warranted clarification. However, the task force did not agree that the term "included" would be appropriate in this context because it would weaken the thought that a precondition for an EOM is appropriate presentation and disclosure in the financial statements. That is, the term "included" would not reflect the fact that an EOM is intended to point directly to the relevant note disclosures in the financial statements that more fully describe or explain the matter. In addition, it would be meaningless for an EOM to highlight an individual item "included" in the balance sheet or income statement that is not further explained in the notes – it is not a responsibility of the auditor to explain that item in the EOM for management. Accordingly, the task force proposes that the wording in the closed-off ISA be retained, amended where appropriate to refer consistently to matters "presented and disclosed" in the financial statements.

- ***Does the IAASB agree with the task force's proposal?***

Material Presented

Agenda Item 7-A (Pages 2049 – 2072)	Proposed ISA 705 (Revised and Redrafted) (Mark-up from Feb 07 IAASB Meeting)
Agenda Item 7-B (Pages 2073 – 2096)	Proposed ISA 705 (Revised and Redrafted) (Clean)
Agenda Item 7-C (Pages 2097 – 2106)	Proposed ISA 706 (Revised and Redrafted) (Mark-up from Feb 07 IAASB Meeting)
Agenda Item 7-D (Pages 2107 – 2116)	Proposed ISA 706 (Revised and Redrafted) (Clean)
Agenda Item 7-E (Pages 2117 – 2120)	Summary of Main IAASB Comments from February 2007 Meeting

Drafts to be Discussed during the Meeting

The task force recommends that the IAASB review the mark-up versions of the revised drafts (**Agenda Items 7-A and 7-C**) for discussion during the meeting.

Action Requested

The IAASB is asked to consider the final wording changes presented, and to approve the proposed redrafted ISAs 705 and 706 for exposure.

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