



9 May 2005

To: Members of the Hong Kong Institute of CPAs
All other interested parties

1. **EXPOSURE DRAFT OF PROPOSED HKSA 700
“THE INDEPENDENT AUDITOR’S REPORT ON A COMPLETE
SET OF GENERAL PURPOSE FINANCIAL STATEMENTS”**
2. **IAASB EXPOSURE DRAFTS**
 - **ISA 705 “MODIFICATIONS TO THE OPINION IN THE
INDEPENDENT AUDITOR’S REPORT”**
 - **ISA 706 “EMPHASIS OF MATTER PARAGRAPHS AND
OTHER MATTERS PARAGRAPHS IN THE INDEPENDENT
AUDITOR’S REPORT”**

Comments to be received by 8 July 2005

The Hong Kong Institute of Certified Public Accountants’ (Institute) Auditing and Assurance Standards Committee is seeking comments on the Audit Report Exposure Drafts which have been posted on the Institute’s website at:

<http://www.hkicpa.org.hk/index.php?mainLocation=/professionaltechnical/assurance/exposuredraft/exposuredraft.php>.

In accordance with the Institute’s ISA Convergence Due Process, comments are invited from any interested party and the Institute would like to hear from both those who do agree and those who do not agree with the proposals contained in the Audit Report Exposure Drafts. Comments should be supported by specific reasoning and should be submitted in written form.

To allow your comments on the Audit Report Exposure Drafts to be considered, they are requested to be received by the Institute on or before **8 July 2005**. Comments may be sent by mail, fax or e-mail to:

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89 Queensway
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Fax number (+852) 2865 6776
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Comments will be acknowledged and may be made available for public review unless otherwise requested by the contributor.

Information for commentators

1. Proposed HKSA 700

In December 2004 the IAASB issued revised ISA 700 “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements”. The revised ISA has been posted on the IAASB’s website at: <http://www.ifac.org/IAASB/>.

To attain convergence with the revised ISA 700 the Institute releases an Exposure Draft of proposed HKSA 700 for consultation.

The key aspects of the proposed Standard are:

- It is confined to unmodified audit reports only;
- It sets out a framework to separate audit reporting requirements in connection with a financial statement audit from additional reporting responsibilities;
- It has better explanations of the respective responsibilities of management and auditor;
- It has an updated description of the audit process to reflect the new Audit Risk Standards;
- It provides clarification of the scope of the auditor’s responsibilities with respect to internal control;
- The new report is a two-part report: the first deals with the financial statements, and should be essentially the same for all audits conducted in accordance with HKSAs; the second deals with any additional reporting requirements; and
- The new report makes a reference to the “applicable reporting framework” which is different from the current practice of referring to the “accounting principles generally accepted in Hong Kong”.

2. Proposed ISA 705 and ISA 706

When issuing the revised ISA 700, the IAASB also issued at the same time ISA 701, “Modifications to the Independent Auditor’s Report” to house the requirements on modified auditor’s reports. ISA 701 addresses both modifications to the opinion in the auditor’s report and emphasis of matters paragraphs.

In March 2005, the IAASB issued Exposure Drafts of proposed ISA 705 and ISA 706 for comment which are intended to replace ISA 701.

In accordance with the Institute’s ISA Convergence Due Process, the Institute releases an Invitation to Comment on these two proposed ISAs.

Proposed ISA 705

The proposed ISA 705 establishes standards and provides guidance, including illustrative examples, on circumstances that may result in a modification to the auditor’s opinion on the financial statements.

The key aspects of the proposed Standard are:

- It establishes three types of modified opinions, a qualified opinion (that is, “except for” opinion), an adverse opinion, and a disclaimer of opinion;
- The choice of the types of modified opinions will depend on the auditor’s judgment about the materiality and pervasiveness of the matter giving rise to the modification; and

- It establishes standards and provides guidance on the format and content of such reports, including headings to be used within the report.

Proposed ISA 706

The proposed ISA 706 establishes standards and provides guidance on circumstances when the auditor includes an “emphasis of matter paragraph” or considers whether to include an “other matters paragraph” in the auditor’s report, and on the form and placement of such a paragraph.

The key aspects of the proposed Standard are:

- It describes the need for the auditor’s report to emphasize a matter presented or disclosed in the financial statements or the notes thereto when, in the auditor’s judgment, the matter is both unusual and of fundamental importance to the users’ understanding of the financial statements; and
- It has standards and guidance on requiring the auditor to include other matters in a separate paragraph of the auditor’s report with a heading that indicates that it deals with an other matter, that is, “Other Matters”. This other matters paragraph ordinarily follows the auditor’s opinion and any emphasis of matter paragraph.

3. The Institute’s Plan

It is intended that the proposed HKSA 700, ISA(HKSA) 705 and ISA(HKSA) 706, when finalized, will be applicable for auditor’s reports dated on or after 31 December 2006 (which is also the effective date of the equivalent ISAs).

The extant SAS 600, “Auditors’ report on financial statements” will remain applicable for auditor’s reports dated before 31 December 2006.

9 May 2005
Exposure Drafts

Response Due Date
8 July 2005

ED of proposed HKSA 700

The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements

ED of proposed ISA 705

Modifications to the Opinion in the Independent Auditor's Report

ED of proposed ISA 706

Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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These Exposure Drafts may be filed in the “Exposure Drafts, Invitations to Comment” section of Volume III of the Institute Members’ Handbook.

The Exposure Drafts can also be found on the Institute’s website at:

<http://www.hkicpa.org.hk/professionaltechnical/assurance/exposedraft/>

PROPOSED HONG KONG STANDARD ON AUDITING 700
THE INDEPENDENT AUDITOR’S REPORT ON A COMPLETE SET OF
GENERAL PURPOSE FINANCIAL STATEMENTS¹

(Effective for auditor’s reports dated on or after 31 December 2006)

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Hong Kong Standard on Auditing (HKSA) 700, “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements” should be read in the context of the “Preface to the Hong Kong Standards on Quality Control, Auditing, Assurance and Related Services”, which sets out the application and authority of HKSAs.

¹ This HKSA is applicable for auditor’s reports on financial statements described in paragraph 1 of this HKSA.

Introduction

1. The purpose of this Hong Kong Standard on Auditing (HKSA) is to establish standards and provide guidance on the independent auditor's report issued as a result of an audit of a complete set of general purpose financial statements prepared in accordance with a financial reporting framework that is designed to achieve fair presentation. It also provides guidance on the matters the auditor considers in forming an opinion on those financial statements. As described in HKSA 200, "Objective and General Principles Governing an Audit of Financial Statements", "general purpose financial statements" are financial statements prepared in accordance with a financial reporting framework that is designed to meet the common information needs of a wide range of users.
2. This HKSA addresses circumstances when the auditor is able to express an unqualified opinion and no modification to the auditor's report is necessary. [HKSA 705, "Modifications to the Opinion in the Independent Auditor's Report" establishes standards and provides guidance on circumstances that may result in a modification to the auditor's opinion on the financial statements. HKSA 706, "Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report" establishes standards and provides guidance on circumstances when the auditor includes an "emphasis of matter paragraph" or considers whether to include an "other matters paragraph" in the auditor's report, and on the form and placement of such a paragraph.]
3. *[Not used]*

The Auditor's Report on Financial Statements

4. **The auditor's report should contain a clear expression of the auditor's opinion on the financial statements.**
5. As stated in HKSA 200, the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.
6. Unless required by law or regulation to use different wording, the auditor's opinion on a complete set² of general purpose financial statements prepared in accordance with a financial reporting framework that is designed to achieve fair presentation (for purposes of this HKSA referred to as "financial statements") states whether the financial statements "give a true and fair view" or "are presented fairly, in all material respects", in accordance with the applicable financial reporting framework. These phrases "give a true and fair view" and "are presented fairly, in all material respects", are equivalent. Which of these phrases is used in any particular jurisdiction is determined by the law or regulations governing the audit of financial statements in that jurisdiction, or by established practice in that jurisdiction.
7. In some jurisdictions, law or regulation governing the audit of financial statements may prescribe wording for the auditor's opinion that is different from the phrases described in paragraph 6. Although the auditor may be obliged to use the prescribed wording, the auditor's responsibilities as described in this HKSA for forming the opinion remain the same.
8. 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 the

² As explained in paragraph 35 of HKSA 200, "Objective and General Principles Governing an Audit of Financial Statements", the financial reporting framework determines what constitutes a complete set of financial statements. A complete set of financial statements under Hong Kong Financial Reporting Standards comprises a balance sheet, an income statement, a statement of changes in equity, a cash flow statement and a summary of significant accounting policies and other explanatory notes.

auditor's report (see HKSA 706).

Applicable Financial Reporting Framework

9. The auditor's judgment regarding whether the financial statements give a true and fair view or are presented fairly, in all material respects, is made in the context of the applicable financial reporting framework. As discussed in HKSA 210, "Terms of Audit Engagements", without an acceptable financial reporting framework, the auditor does not have suitable criteria for evaluating the entity's financial statements. HKSA 200 describes the auditor's responsibility to determine whether the financial reporting framework adopted by management in preparing the financial statements is acceptable.
10. In the case of financial statements that are within the scope of this HKSA, application of a financial reporting framework determined to be acceptable for general purpose financial statements will, except in the extremely rare circumstances discussed in paragraph 15, result in financial statements that achieve fair presentation. Although the financial reporting framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficient broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework. Thus, the financial reporting framework provides a context for the auditor's evaluation of the fair presentation of the financial statements, including whether the financial statements have been prepared and presented in accordance with the specific requirements of the applicable financial reporting framework for particular classes of transactions, account balances and disclosures.

Forming an Opinion on the Financial Statements

11. **The auditor should evaluate the conclusions drawn from the audit evidence obtained as the basis for forming an opinion on the financial statements.**
12. When forming an opinion on the financial statements, the auditor evaluates whether, based on the audit evidence obtained, there is reasonable assurance about whether the financial statements taken as a whole are free from material misstatement. This involves concluding whether sufficient appropriate audit evidence has been obtained to reduce to an acceptably low level the risks of material misstatement³ and evaluating the effects of uncorrected misstatements identified.⁴
13. Forming an opinion as to whether the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework involves evaluating whether the financial statements have been prepared and presented in accordance with the specific requirements of the applicable financial reporting framework for particular classes of transactions, account balances and disclosures. This evaluation includes considering whether, in the context of the applicable financial reporting framework:
 - (a) The accounting policies selected and applied are consistent with the financial reporting framework and are appropriate in the circumstances;
 - (b) The accounting estimates made by management are reasonable in the circumstances;
 - (c) The information presented in the financial statements, including accounting policies, is relevant, reliable, comparable and understandable; and
 - (d) The financial statements provide sufficient disclosures to enable users to understand the effect of material transactions and events on the information conveyed in the financial statements, for example, in the case of financial statements prepared in accordance with Hong Kong Financial Reporting Standards (HKFRSs), the entity's financial position, financial performance and cash flows.

³ See HKSA 330, "The Auditor's Procedures in Response to Assessed Risks".

⁴ See HKSA 320, "Audit Materiality".

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

Extremely Rare Circumstances when Applying the Financial Reporting Framework Results in Misleading Financial Statements

15. As discussed in HKSA 210, the auditor considers the acceptability of the financial reporting framework when considering accepting the engagement. Application of a financial reporting framework determined to be acceptable for general purpose financial statements will ordinarily result in financial statements that achieve fair presentation. In extremely rare circumstances, however, application of a specific requirement in a framework that has been determined to be acceptable for general purpose financial statements may result in financial statements that are misleading in the particular circumstances of the entity. Some financial reporting frameworks determined to be acceptable for general purpose financial statements acknowledge, implicitly or explicitly, that there are extremely rare circumstances when it is necessary for the financial statements to depart from a specific requirement in the framework in order to achieve the objective of fair presentation of the financial statements and provide guidance on the disclosures required. Other financial reporting frameworks may not provide any guidance on these circumstances even though they are acceptable frameworks for general purpose financial statements. If the auditor encounters circumstances that lead the auditor to conclude that compliance with a specific requirement results in financial statements that are misleading, the auditor considers the need to modify the auditor's report. The modifications, if any, that are appropriate to the auditor's report will depend on how management addresses the matter in the financial statements and how the financial reporting framework deals with these rare circumstances (see HKSA 705 and HKSA 706).

Elements of the Auditor's Report in an Audit Conducted in Accordance with Hong Kong Standards on Auditing⁵

16. Consistency in the auditor's report, when the audit has been conducted in accordance with the HKSAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. It also helps to promote the reader's understanding and to identify unusual circumstances when they occur.
17. Paragraphs 18-60 set out the requirements relating to the following elements of the auditor's report when the audit has been conducted in accordance with the HKSAs:
- (a) Title;
 - (b) Addressee;
 - (c) Introductory paragraph;
 - (d) Management's responsibility for the financial statements;
 - (e) Auditor's responsibility;

⁵ Paragraphs 61-66 address the auditor's report when the audit has been conducted in accordance with both HKSAs and auditing standards of a specific jurisdiction or country (including International Standards on Auditing).

- (f) Auditor's opinion;
- (g) Other reporting responsibilities;
- (h) Auditor's signature;
- (i) Date of the auditor's report; and
- (j) Auditor's address.

Title

- 18. **The auditor's report should have a title that clearly indicates that it is the report of an independent auditor.**
- 19. A title indicating the report is the report of an independent auditor, for example, "Independent Auditor's Report," affirms that the auditor has met all of the relevant ethical requirements regarding independence and, therefore, distinguishes the independent auditor's report from reports issued by others.

Addressee

- 20. **The auditor's report should be addressed as required by the circumstances of the engagement.**
- 21. National laws or regulations often specify to whom the auditor's report on general purpose financial statements should be addressed in that particular jurisdiction. Ordinarily, the auditor's report on general purpose financial statements is addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.

Introductory Paragraph

- 22. **The introductory paragraph in the auditor's report should identify the entity whose financial statements have been audited and should state that the financial statements have been audited. The introductory paragraph should also:**
 - (a) **Identify the title of each of the financial statements that comprise the complete set of financial statements;**
 - (b) **Refer to the summary of significant accounting policies and other explanatory notes; and**
 - (c) **Specify the date and period covered by the financial statements.**
- 23. This requirement is ordinarily met by stating that the auditor has audited the accompanying financial statements of the entity, which comprise [state the titles of the complete set of financial statements required by the applicable financial reporting framework, specifying the date and period covered by those financial statements] and referring to the summary of significant accounting policies and other explanatory notes. In addition, when the auditor is aware that the financial statements will be included in a document that contains other information, such as an annual report, the auditor may consider, if the form of presentation allows, identifying the page numbers on which the financial statements are presented. This helps readers to identify the financial statements to which the auditor's report relates.
- 24. The auditor's opinion covers the complete set of financial statements as defined by the applicable financial reporting framework. In the case of financial statements prepared in accordance with HKFRSs, this includes: a balance sheet, an income statement, a statement of changes in equity, a cash flow statement, and a summary of significant accounting policies and other explanatory notes. In some jurisdictions additional information might also be considered to be an integral part of the financial statements.
- 25. In some circumstances, the entity may be required by law or regulation or standards, or may voluntarily choose, to present together with the financial statements supplementary information

that is not required by the financial reporting framework. For example, supplementary information might be presented to enhance a user's understanding of the financial reporting framework or to provide further explanation of specific financial statement items. Such information is normally presented in either supplementary schedules or as additional notes. The auditor's opinion may or may not cover the supplementary information and it is therefore important for the auditor to be satisfied that any supplementary information that is not covered by the auditor's opinion is clearly differentiated, as discussed in paragraphs 67-71.

26. In some circumstances, the supplementary information cannot be clearly differentiated from the financial statements because of its nature and how it is presented. Such supplementary information is covered by the auditor's opinion. For example, the auditor's opinion covers notes or supplementary schedules that are cross-referenced from the financial statements. This would also be the case when the notes to the financial statements include an explanation of the extent to which the financial statements comply with another financial reporting framework.
27. Supplementary information that is presented as an integral part of the financial statements does not need to be specifically referred to in the introductory paragraph of the auditor's report when the reference to the notes in the description of the components of the financial statements in the introductory paragraph is sufficient.

Management's Responsibility for the Financial Statements

28. **The auditor's report should state that management is responsible for the preparation and the fair presentation of the financial statements in accordance with the applicable financial reporting framework and that this responsibility includes:**
 - (a) **Designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error;**
 - (b) **Selecting and applying appropriate accounting policies; and**
 - (c) **Making accounting estimates that are reasonable in the circumstances.**
29. Financial statements are the representations of management. Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework. For example, in the case of financial statements prepared in accordance with HKFRSs, management is responsible for preparing financial statements that fairly present the financial position, financial performance and cash flows of the entity in accordance with HKFRSs. To fulfill this responsibility, management designs and implements internal control⁶ to prevent or to detect and correct misstatements, whether due to fraud or error, in order to ensure the reliability of the entity's financial reporting. The preparation of the financial statements requires management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.
30. There may be circumstances when it is appropriate for the auditor to add to the description of management's responsibilities in paragraph 28 to reflect additional responsibilities that are relevant to the preparation and presentation of the financial statements in the context of the particular jurisdiction or the nature of the entity.
31. The term management has been used in this HKSA to describe those responsible for the preparation and fair presentation of the financial statements. Other terms may be appropriate depending on the legal framework in the particular jurisdiction. For example, in some jurisdictions, the appropriate reference may be to those charged with governance (for example,

⁶ In some jurisdictions, law or regulation prescribing management's responsibilities may specifically refer to a responsibility for the adequacy of accounting books and records, or accounting system. As books, records and systems are an integral part of internal control (as defined in HKSA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement"), no specific reference is made to them in paragraph 28 for the description of management's responsibilities.

the directors).

Auditor's Responsibility

32. **The auditor's report should state that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.**
33. The auditor's report states that the auditor's responsibility is to express an opinion on the financial statements based on the audit in order to contrast it to management's responsibility for the preparation and fair presentation of the financial statements.
34. **The auditor's report should state that the audit was conducted in accordance with Hong Kong Standards on Auditing. The auditor's report should also explain that those standards require that the auditor comply with ethical requirements and that the auditor plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.**
35. The reference to the standards used conveys to the reader that the audit has been conducted in accordance with established standards.
36. HKSA 200 specifies what is required in order to conduct an audit in accordance with the HKSAs. Paragraph 14 in that HKSA explains that the auditor cannot describe the audit as being conducted in accordance with the HKSAs unless the auditor has complied fully with all of the HKSAs relevant to the audit.
37. **The auditor's report should describe an audit by stating that:**
 - (a) **An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements;**
 - (b) **The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor should omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of internal control; and**
 - (c) **An audit also includes evaluating the appropriateness of the accounting policies used, the reasonableness of accounting estimates made by management, as well as the overall presentation of the financial statements.**
38. **The auditor's report should state that the auditor believes that the audit-evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.**

Auditor's Opinion

39. **An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.**
40. **When expressing an unqualified opinion, the opinion paragraph of the auditor's report should state the auditor's opinion that the financial statements give a true and fair view or present fairly, in all material respects, in accordance with the applicable financial reporting framework (unless the auditor is required by law or regulation to use different wording for the opinion, in which case the prescribed wording should be used).**

41. **When Hong Kong Financial Reporting Standards are not used as the financial reporting framework, the reference to the financial reporting framework in the wording of the opinion should identify the jurisdiction or country of origin of the financial reporting framework.**
42. The auditor's opinion states that the financial statements give a true and fair view of or present fairly, in all material respects, the information that the financial statements are designed to convey (which is determined by the financial reporting framework). For example, in the case of financial statements prepared in accordance with HKFRs, the auditor expresses an opinion that the financial statements give a true and fair view of or are presented fairly, in all material respects, the financial position of the entity as at the end of the period and the entity's financial performance and cash flows for the period then ended.
43. To advise the reader of the context in which the auditor's opinion is expressed, the auditor's opinion identifies the applicable financial reporting framework on which the financial statements are based. When the applicable financial reporting framework is not HKFRSs, the auditor's opinion also identifies the jurisdiction or country of origin of the applicable financial reporting framework. The auditor identifies the applicable financial reporting framework in such terms as:
 - "... in accordance with Hong Kong Financial Reporting Standards" or
 - "... in accordance with accounting principles generally accepted in Country X ..."
44. When the applicable financial reporting framework encompasses legal and regulatory requirements, the auditor identifies the applicable financial reporting framework in such terms as:

"... in accordance with Hong Kong Financial Reporting Standards and the requirements of Country X Corporations Act"^{6a}.

Other Matters

45. Standards, laws or generally accepted practice in a jurisdiction may require or permit the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon. Such matters may be addressed in a separate paragraph following the auditor's opinion.

Other Reporting Responsibilities

46. In some jurisdictions, the auditor may have additional responsibilities to report on other matters that are supplementary to the auditor's responsibility to express an opinion on the financial statements. For example, the auditor may be asked to report certain matters if they come to the auditor's attention during the course of the audit of the financial statements. Alternatively, the auditor may be asked to perform and report on additional specified procedures, or to express an opinion on specific matters, such as the adequacy of accounting books and records. Auditing standards in the specific jurisdiction or country often provide guidance on the auditor's responsibilities with respect to specific additional reporting responsibilities in that jurisdiction or country.
47. In some cases, the relevant standards or laws may require or permit the auditor to report on these other responsibilities within the auditor's report on the financial statements. In other cases, the auditor may be required or permitted to report on them in a separate report.
48. **When the auditor addresses other reporting responsibilities within the auditor's report on the financial statements, these other reporting responsibilities should be addressed in a separate section in the auditor's report that follows the opinion paragraph.**
49. The auditor addresses 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.

^{6a} For companies incorporated in Hong Kong, the applicable Corporations Act is the Companies Ordinance.

Auditor's Signature

50. The auditor's report should be signed.

51. The auditor's signature is either in the name of the audit firm, the personal name of the auditor or both, as appropriate for the particular jurisdiction. In addition to the auditor's signature, in certain jurisdictions, the auditor may be required to declare the auditor's professional accountancy designation or the fact that the auditor or firm, as appropriate, has been recognized by the appropriate licensing authority in that jurisdiction.

Date of the Auditor's Report

52. The auditor should date the report on the financial statements no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements. Sufficient appropriate audit evidence should include evidence that the entity's complete set of financial statements has been prepared and that those with the recognized authority have asserted that they have taken responsibility for them.

53. The date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date. The auditor's responsibility for events and transactions after the date of the auditor's report is addressed in HKSA 560, "Subsequent Events."

54. Since the auditor's opinion is provided on the financial statements and the financial statements are the responsibility of management, the auditor is not in a position to conclude that sufficient appropriate audit evidence has been obtained until the auditor obtains evidence that a complete set of financial statements has been prepared and management has accepted responsibility for them.

55. In some jurisdictions, the law or regulation identifies the individuals or bodies (for example, the directors) that are responsible for concluding that a complete set of financial statements has been prepared, and specifies the necessary approval process. In such cases, the auditor obtains evidence of that approval before dating the report on the financial statements.⁷ In other jurisdictions, however, the approval process is not prescribed in law or regulation. In such cases, the auditor takes into account the procedures the entity follows in preparing and finalizing its financial statements in view of its management and governance structures in order to identify the individuals or body with the authority to conclude that the entity's complete set of financial statements, including the related notes, has been prepared.

56. In some jurisdictions, final approval of the financial statements by shareholders is required before the financial statements are issued publicly. In these jurisdictions, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence has been obtained. The date of approval of the financial statements for purposes of the HKSAs is the earlier date on which those with the recognized authority determine that a complete set of financial statements has been prepared.

Auditor's Address

- 57. The report should name the location in the country or jurisdiction where the auditor practices.**

Auditor's Report

58. The auditor's report should be in writing.

59. A written report encompasses both reports issued in hard copy format and those using an electronic medium.

60. The following is an illustration of the auditor's report incorporating the elements set forth above for an audit of financial statements prepared in accordance with HKFRSs expressing an

⁷ In rare circumstances, law or regulation also identifies the point in the financial statement reporting process at which the audit is expected to be complete.

unqualified opinion. In addition to the audit of the financial statements, the illustration assumes that the auditor has other reporting responsibilities required under local law.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements⁸

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at 31 December 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Hong Kong Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Hong Kong Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.⁹ An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements give a true and fair view of (*or "present fairly, in all material respects,"*) the financial position of ABC Company as of 31 December 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards.

⁸ The subheading "Report on the Financial Statements" is unnecessary in circumstances when the second subheading "Report on Other Legal and Regulatory Requirements" is not applicable.

⁹ In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances."

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Auditor's Report for Audits Conducted in Accordance with Both HKSA's and Auditing Standards of a Specific Jurisdiction or Country (including International Standards on Auditing)

61. The auditor may conduct the audit in accordance with both the HKSA's and the auditing standards of a specific jurisdiction or country (including International Standards on Auditing) (for purposes of this HKSA referred to as "national auditing standards").
62. **The auditor's report should refer to the audit having been conducted in accordance with the Hong Kong Standards on Auditing only when the auditor has complied fully with all of the Hong Kong Standards on Auditing relevant to the audit.**
63. The auditor may refer to the audit having been conducted in accordance with both HKSA's as well as national auditing standards when the auditor complies with each of the HKSA's relevant to the audit and performs any additional audit procedures necessary to comply with the relevant standards of that jurisdiction or country. A reference to both the HKSA's and national auditing standards is not appropriate if there is a conflict between the reporting requirements regarding the auditor's report in the HKSA's and in the 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 HKSA 706 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 HKSA's or the relevant national auditing standards) in accordance with which the auditor has complied with the reporting requirements.
64. **When the auditor's report refers to both Hong Kong Standards on Auditing and auditing standards of a specific jurisdiction or country, the auditor's report should identify the jurisdiction or country of origin of the auditing standards.**
65. **When the auditor prepares the auditor's report using the layout or wording specified by the law, regulation or auditing standards of the specific jurisdiction or country, the auditor's report should refer to the audit being conducted in accordance with both Hong Kong Standards on Auditing and the auditing standards of the specific jurisdiction or country only if the auditor's report includes, at a minimum, each of the following elements:**
 - (a) **A title;**
 - (b) **An addressee, as required by the circumstances of the engagement;**
 - (c) **An introductory paragraph that identifies the financial statements audited;**
 - (d) **A description of management's responsibility for the preparation and fair presentation of the financial statements;**
 - (e) **A description of the auditor's responsibility to express an opinion on the financial statements and the scope of the audit, that includes:**

- (i) **A reference to the Hong Kong Standards on Auditing and the auditing standards of the specific jurisdiction or country, and**
 - (ii) **A description of the work an auditor performs in an audit.**
- (f) **An opinion paragraph containing an expression of opinion on the financial statements¹⁰ and a reference to the applicable financial reporting framework used to prepare the financial statements (including identifying the country of origin of the financial reporting framework when Hong Kong Financial Reporting Standards are not used);**
- (g) **The auditor’s signature;**
- (h) **The date of the auditor’s report; and**
- (i) **The auditor’s address.**
66. The auditor may be obliged by national law or regulation to use a layout or wording in the auditor’s report that differs from that described in this HKSA. When the differences only relate to the layout and wording of the auditor’s report, the auditor will be considered to have complied with the reporting requirements of the HKSAs provided that the auditor’s report includes, at a minimum, each of the elements identified in paragraph 65 – even if using the layout and wording specified by national laws or regulations. Where specific requirements in a particular jurisdiction do not conflict with HKSAs, the auditor adopts the layout and wording used in this HKSA so that users can more readily recognize the auditor’s report as a report on an audit conducted in accordance with HKSAs.

Unaudited Supplementary Information Presented with Audited Financial Statements

67. **The auditor should be satisfied that any supplementary information presented together with the financial statements that is not covered by the auditor’s opinion is clearly differentiated from the audited financial statements.**
68. As noted in paragraphs 25-26, the entity may be required to, or management may choose to, include supplementary information together with the financial statements. The auditor’s opinion is considered to cover supplementary information that cannot be clearly differentiated from the financial statements because of its nature and how it is presented. In other circumstances, however, law or regulation may not require the supplementary information to be audited and management may not ask the auditor to include the supplementary information within the scope of the audit of the financial statements. When the supplementary information is not intended to be audited, the auditor considers whether that supplementary information is presented in a manner that could be construed as being covered by the auditor’s opinion and, if so, asks management to change how the information is presented. The auditor considers, for example, where the unaudited information is presented in relation to the financial statements and any audited supplementary information, and whether it is clearly labeled as “unaudited.” The auditor asks management to remove any cross references from the financial statements to unaudited supplementary schedules or unaudited notes because the demarcation between the audited and unaudited information would not be sufficiently clear. Unaudited notes that are intermingled with the audited notes can also be misinterpreted as being audited. Therefore, the auditor asks the entity to place the unaudited information outside of the set of financial statements, or, if that is not possible in the circumstances, at a minimum, place the unaudited notes together at the

¹⁰ Circumstances when the auditor needs to modify the auditor’s opinion are addressed in HKSA 705, “Modifications to the Opinion in the Independent Auditor’s Report”. In some circumstances, the auditor may not be able to express an opinion on the financial statements because the effect of a limitation on the scope of the audit is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence. In such circumstances, the auditor expresses a disclaimer of opinion.

end of the required notes to the financial statements and clearly label them as unaudited.

69. As noted in paragraph 23, when the auditor is aware that the financial statements will be included in a document that contains other information, the auditor may consider, if the form of presentation allows, identifying the page numbers on which the audited financial statements are presented in the auditor's report. This helps readers differentiate the financial statements from other information not covered by the auditor's opinion.
70. **If the auditor concludes that the entity's presentation of any unaudited supplementary information does not differentiate it sufficiently from the audited financial statements, the auditor should explain in the auditor's report that that information has not been audited.**
71. The fact that supplementary information is unaudited does not relieve the auditor of the responsibility to read that information to identify material inconsistencies with the audited financial statements. The auditor's responsibilities with respect to unaudited supplementary information are consistent with those described in HKSA 720, "Other Information in Documents Containing Audited Financial Statements".

Effective Date

72. This HKSA is effective for auditor's reports dated on or after 31 December 2006.

Conformity and compliance with International Standards on Auditing

73. As of (date of issue), this HKSA confirms with International Standard on Auditing (ISA) 700 (Revised), "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements". Compliance with the requirements of this HKSA ensures compliance with ISA 700 (Revised).
74. Additional local explanation is provided in footnote 6a.

Public Sector Perspective

1. *Some terms in this HKSA such as "engagement partner" and "firm" should be read as referring to their public sector equivalents.*
2. *In the public sector, legislation governing the audit mandate may specify the layout of or words to be used in the auditor's report. When the auditor prepares the auditor's report using the layout or wording specified in such legislation, the auditor's report should refer to the audit being conducted in accordance with HKSAs, and the legislation governing the audit mandate, only if the auditor's report includes, at a minimum, each of the elements specified in paragraph 65(a)-(j). As discussed in paragraph 66, where legislation governing the audit mandate does not conflict with HKSAs, the auditor adopts the layout and wording used in this HKSA so that users can more readily recognize the auditor's report as a report on an audit conducted in accordance with HKSAs.*
3. *In addition, such legislation may specify the responsibilities of management and auditors in relation to the audit. The descriptions of such responsibilities included in the auditor's report will need to reflect the requirements of the legislation.*

Proposed International Standard on Auditing ISA 705

Modifications to the Opinion in the Independent Auditor's Report

Proposed International Standard on Auditing ISA 706

Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report



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REQUEST FOR COMMENTS

This exposure draft of the International Auditing and Assurance Standards Board (IAASB) was approved for publication in March 2005. The proposed International Standards on Auditing (ISAs) and proposed conforming amendments to other ISAs may be modified in light of comments received before being issued in final form.

Comments should be submitted so as to be received by **July 31, 2005** preferably by e-mail or on computer disk, or in writing. All comments will be considered a matter for the public record. Comments should be addressed to:

Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Email responses should be sent to: Edcomments@ifac.org

The approved text of this exposure draft is published in the English language. In order to achieve maximum exposure and feedback, the International Federation of Accountants encourages the reproduction of this publication in any format.

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EXPLANATORY MEMORANDUM

Introduction

This memorandum provides some background to, and an explanation of, the proposed International Standard on Auditing (ISA) 705 (previously ISA 701) under the new title of “Modifications to the Opinion in the Independent Auditor’s Report,” and the proposed ISA 706, “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

When extant ISA 700, “The Auditor’s Report on Financial Statements” was revised, the IAASB agreed to restrict the revised ISA¹ to auditors’ reports when the auditor is able to express an unmodified opinion and no other modifications to the auditor’s report are necessary. The standards and guidance on modifications to the auditor’s report in extant ISA 700 were moved to ISA 701, “Modifications to the Independent Auditor’s Report.”² To increase consistency in reporting among jurisdictions, the IAASB undertook to revise ISA 701 to enhance the standards and guidance on modifications to the auditor’s opinion and emphasis of matter paragraphs.

Significant Proposals

ISA Numbering

The revision of extant ISA 700 did not only give rise to ISA 701 and the revision of ISA 701, but also to the revision of extant ISA 800, “The Auditor’s Report on Special Purpose Audit Engagements.”

As explained below, the IAASB proposes that the standards and guidance on emphasis of matter paragraphs and other matters paragraphs (currently in ISA 701) are presented in a separate ISA. The IAASB is also proposing that the standards and guidance on the auditor’s report on summarized audited historical financial information (currently in ISA 800) are presented in a separate ISA.

To clarify the interrelationship between the proposed revised and new ISAs, it is intended to renumber them as follows:

- ISA 700 (Revised), “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements” (No change to the ISA number.)
- ISA 701, “The Independent Auditor’s Report on Other Historical Financial Information” (That is, the current ISA 800, “The Independent Auditor’s Report on Special Purpose Audit Engagements,” which is subject to revision and exposure later in 2005. The scope of the proposed revised ISA is expanded to address historical financial information other than that covered by the auditors’ reports in ISA 700 (Revised).)

¹ 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 auditors’ reports dated on or after December 31, 2006.

² ISA 701 was issued at the same time as ISA 700 (Revised) and has the same effective date.

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- ISA 705, “Modifications to the Opinion in the Independent Auditor’s Report” (Providing standards and guidance on modified opinions in auditors’ reports on historical financial information referred to in both ISA 700 (Revised) and proposed ISA 701 (Revised).)
- ISA 706, “Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor’s Report” (Providing standards and guidance on emphasis of matter paragraphs and other matters paragraphs in auditors’ reports on historical financial information referred to in both ISA 700 (Revised) and proposed ISA 701 (Revised).)
- New ISA 800, “The Independent Auditor’s Report on Summarized Audited Historical Financial Information” (Incorporating paragraphs 21-25 of current ISA 800, which are subject to revision and exposure later in 2005.)

Split Between ISA 705 and ISA 706

The current ISA 701 addresses both modifications to the opinion in the auditor’s report and emphasis of matter paragraphs.

The IAASB believes that the ISAs should more clearly recognize the difference between modified opinions, and emphasis of matter paragraphs or other matters paragraphs which do not give rise to a modification to the opinion. Accordingly, the IAASB proposes to split the related standards and guidance. Modifications to the opinion in the auditor’s report are covered in the proposed ISA 705, and emphasis of matter paragraphs and other matters paragraphs in the auditor’s report are covered in the proposed ISA 706.

Terminology

Modified Opinion vs. Modified Report

The IAASB is concerned that the use of the term “modified” in current ISA 701 to mean both modifications to the auditor’s opinion and the inclusion of an emphasis of matter paragraph in the auditor’s report may cause confusion. For example, jurisdictions that translate the ISAs have found it difficult to explain the difference between a qualified opinion and a modified auditor’s report. Consequently, it is proposed that the term “modified” is used only in the context of modifications to the opinion in the auditor’s report. In future, the term “modified auditor’s report” will not to be used in the ISAs.

Modifications to the Opinion and Modified Opinions vs. Qualifications to the Opinion and Qualified Opinions

The IAASB believes that neither a disclaimer of opinion nor an adverse opinion can be described as a qualified opinion; such opinions are not qualified in any way. Thus, the exposure draft uses the term “modifications to the opinion” to describe qualified opinions (“except for” opinions), adverse opinions, and disclaimers of opinion.

Proposed ISA 705

The proposed ISA 705 establishes standards and provides guidance on (a) circumstances that may result in a modification to the opinion in the auditor's report, (b) the type of opinion appropriate in the circumstances, and (c) the form and content of the auditor's report when the auditor's opinion is modified.

The proposed ISA establishes three types of modified opinions, a qualified opinion (that is, "except for" opinion) an adverse opinion, and a disclaimer of opinion, the choice of which will depend on the auditor's judgment about the materiality and pervasiveness of the matter giving rise to the modification.

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

- (a) 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.
- (b) 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.

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. The proposed ISA establishes standards and provides guidance on the format and content of such reports, including headings to be used within the report. It also contains illustrative auditors' reports.

Proposed ISA 706

The proposed ISA 706 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. It describes the need for the auditor's report to emphasize a matter presented or disclosed in the financial statements or the notes thereto when, in the auditor's judgment, the matter is both unusual and of fundamental importance to the users' understanding of the financial statements.

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 an emphasis of matter paragraph. 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.

Effective Date

The IAASB recommends that the proposed ISAs 705 and 706 are effective for auditors' reports dated 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 ISAs 705 and 706. 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.

While the IAASB is seeking comments on all matters addressed in the exposure draft, the IAASB is also interested in comments on the following questions:

1. The proposed ISA 706 requires the auditor to include an emphasis of matter paragraph in the auditor's report when a significant uncertainty is both unusual and of fundamental importance to the user's understanding of the financial statements. The proposed ISA 705, however, permits the auditor to issue a disclaimer of opinion in the case of multiple uncertainties. Paragraph 33 states: "In extreme cases involving multiple uncertainties, the auditor may, however, conclude that the cumulative nature and possible effect of the multiple uncertainties are such that it is not possible to form an opinion and, accordingly, the auditor expresses a disclaimer of opinion." This guidance was taken from the current ISA 701. The IAASB concluded that it is important to retain this guidance, which is to be applied in extreme circumstances involving multiple uncertainties. The IAASB, however, is concerned that this guidance may make it difficult for practitioners to know when to include an emphasis of matter paragraph and when to disclaim an opinion in the auditor's report in the case of multiple uncertainties.

The IAASB would appreciate the views of respondents as to whether paragraph 33 of ISA 705 should be retained.

2. The proposed ISA 705 mandates the use of sub-headings in the auditors' report because they will highlight the modification to the opinion for the reader of the auditor's report and, as a result, drive consistency of practice.

The IAASB would appreciate views of respondents on whether the use of sub-headings is desirable in auditors' reports with modifications to the opinion and auditors' reports with an emphasis of matter paragraph or an other matters paragraph.

3. The proposed ISA 706, paragraph 12, uses the term "significant uncertainty" as an example of a matter that the auditor includes in an emphasis of matter paragraph in the auditor's report if, in the auditor's judgment, it is both unusual and of fundamental importance to the user's understanding of the financial statements. ISA 570, "Going Concern," however, uses the term "material uncertainty." ISA 570, in footnote 3 to paragraph 8, explains that: "The phrase 'material uncertainty' is used in IAS 1 in discussing uncertainties related to

EXPLANATORY MEMORANDUM

events or conditions which may cast significant doubt on the enterprise's ability to continue as a going concern that should be disclosed in the financial statements. In other financial reporting frameworks, and elsewhere in the ISAs, the phrase 'significant uncertainties' is used in similar circumstances."

Do you believe that the use of the terms "significant uncertainty" and "material uncertainty" causes confusion? If so, why?

Special Considerations in the Audits of Small Entities

Consistent with the IAASB's decision to include any special considerations relevant to the audit of small entities within the text of the ISAs themselves, the guidance in paragraphs 102-105 of International Auditing Practice Statement (IAPS) 1005, "The Special Considerations in the Audit of Small Entities," has been revised as considered necessary and incorporated in this proposed ISA. Consequently, paragraphs 102-105 of IAPS 1005 **will be withdrawn** when the proposed ISA 705 becomes effective. 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 ISAs 705 and 706. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

Special Considerations in the Audit of Public Sector Entities

Where considered necessary, any special considerations in the audit of public sector entities have also been included in the proposed ISAs. These issues were addressed with the assistance of a nominee of the Auditing Standards Committee of the International Organization of Supreme Audit Institutions. Respondents are asked to comment on whether, in their opinion, special considerations in the audit of public sector entities have been dealt with appropriately in the proposed ISAs. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

Developing Nations

Recognizing that many developing nations have adopted or are in the process of adopting the ISAs, the IAASB invites respondents from these nations to comment, in particular, on any foreseeable difficulties in applying the proposed revised ISA in a developing nation environment. Reasons should be provided, as well as alternative or additional guidance.

Translations

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

PROPOSED INTERNATIONAL STANDARD ON AUDITING 705
(Derived from ISA 701)

**MODIFICATIONS TO THE OPINION IN THE
INDEPENDENT AUDITOR’S REPORT**
(Effective for auditors’ reports dated on or after
December 31, 2006)

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International Standard on Auditing (ISA) 705, “Modifications to the Opinion in the Independent Auditor’s Report” should be read in the context of the “Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services,” which sets out the application and authority of ISAs.
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Introduction

1. This International Standard on Auditing (ISA) establishes standards and provides guidance on (a) circumstances that may result in a modification to 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.
2. ISA 700 (Revised), "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements," establishes standards and provides guidance on the independent auditor's report issued as a result of an audit of a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation.
3. ISA 800, "The Independent Auditor's Report on Special Purpose Audit Engagements," establishes standards and provides guidance on the independent auditor's report issued as a result of an audit of:
 - (a) A complete set of financial statements prepared in accordance with an other comprehensive basis of accounting;
 - (b) A component of a complete set of general purpose or special purpose financial statements, such as a single financial statement, specified accounts, elements of accounts, or items in a financial statement;
 - (c) Compliance with contractual agreements; and
 - (d) Summarized financial statements.¹
4. Both ISA 700 (Revised) and ISA 800 address circumstances when the auditor is able to express an unmodified opinion and no other changes to the auditor's report are necessary. The standards and guidance in this ISA are to be applied in circumstances when the auditor modifies the opinion paragraph in the auditor's report issued as a result of an audit of a complete set of general purpose financial statements or a special purpose audit engagement. The illustrative reports in this ISA (see Appendix) are based on the form and content of the auditor's report on a complete set of general purpose financial statements.
5. In contrast to this ISA, which addresses modifications to the auditor's opinion, [proposed] ISA 706, "Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report," establishes standards and provides guidance when the auditor considers including an emphasis of matter paragraph or an other matters paragraph in the auditor's report.

¹ The IAASB is currently revising ISA 800 to expand its scope to cover auditors' reports on historical financial information other than a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation, which is covered in ISA 700 (Revised). The proposed ISA 705 applies to engagements that fall within ISA 700 (Revised) and those that will fall within the proposed revised ISA 800. On finalization of the proposed revised ISA 800 (expected to be exposed for public comment later this year), this paragraph will be amended to conform to ISA 800 (Revised).

6. ISA 200, "Objective and General Principles Governing an Audit of Financial Statements," states that the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. The auditor evaluates the conclusions drawn from the audit evidence obtained as a basis for forming an opinion on the financial statements.
7. **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.**

Circumstances Resulting in a Modification to the Auditor's Opinion

8. In forming the opinion on the financial statements, as described in paragraph 6, the auditor evaluates whether the financial statements have been prepared and presented in accordance with the specific requirements of the applicable financial reporting framework. 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^{2,3} 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).
9. This ISA establishes three types of modified opinions, namely, a qualified opinion, an adverse opinion, and a disclaimer of opinion, the choice of which will depend upon the auditor's judgment about the materiality and pervasiveness of the matter giving rise to the modification.

² A disagreement with management also encompasses the instance where management acknowledges that the financial statements contain a departure from the applicable financial reporting framework but management refuses to amend the financial statements for reasons such as cost-benefit considerations.

³ The term "management" used in this ISA describes those responsible for the preparation and presentation of the financial statements. Other terms may be appropriate depending on the legal framework in the particular jurisdiction. For example, in some jurisdictions, the appropriate reference may be to those charged with governance (for example, the directors).

Disagreements with Management

- (a) The auditor expresses a qualified opinion (see paragraph 25) when the auditor concludes that the effect of any disagreement with management, while material, is not pervasive; accordingly, except for the matter giving rise to the modification, the financial statements are prepared in accordance with the applicable financial reporting framework and are not misleading; thus they do not require an adverse opinion.
- (b) The auditor expresses an adverse opinion (see paragraph 28) when the auditor concludes that the effect of a disagreement with management is material and pervasive to the financial statements such that a qualified opinion is not adequate to disclose the misleading nature of the financial statements.

Inability to Obtain Sufficient Appropriate Audit Evidence

- (c) The auditor expresses a qualified opinion (see paragraph 25) when the auditor concludes that the possible effect of an inability to obtain sufficient appropriate audit evidence, while material, in the auditor's judgment could not be pervasive; therefore, the financial statements are not misleading and do not require a disclaimer of opinion. This may be the case when it is possible to determine and clearly describe in the auditor's report which financial statement line items are or may be affected by the inability to obtain sufficient appropriate audit evidence.
- (d) The auditor expresses a disclaimer of opinion (see paragraph 31) 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.

See paragraph 23 for a discussion of materiality and paragraph 24 for a discussion of pervasiveness.

MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT

10. The table below illustrates how the auditor's judgment about the nature, materiality and pervasiveness of the matter giving rise to the modification affects the type of opinion to be expressed.

Nature of Matter Giving Rise to the Modification \ Affects or Possibly Affects the Financial Statements	Materially	Materially and Pervasively
Disagreement with Management	A Qualified Opinion (See paragraph 25)	B Adverse Opinion (See paragraph 28)
Inability to Obtain Sufficient Appropriate Audit Evidence	C Qualified Opinion (See paragraph 25)	D Disclaimer of Opinion (See paragraph 31)

Disagreement with Management

11. **The auditor should express a qualified opinion when disagreements with management are material, but not pervasive, to the financial statements. When disagreements with management are material and pervasive to the financial statements, the auditor should express an adverse opinion.** As discussed in paragraph 8(a), the auditor may disagree with management about the following matters:

- The acceptability of selected accounting policies within the financial reporting framework;
- The application of the selected accounting policies; or
- The adequacy of disclosures in the financial statements.

Acceptability of Selected Accounting Policies

12. Disagreements with management about the acceptability of the selected accounting policies may arise when:

- The selected accounting policies are not consistent with the applicable financial reporting framework;
- The selected accounting policies are not appropriate in the circumstances and, accordingly, the overall presentation of and disclosures in the financial statements are not consistent with the auditor's understanding of the entity and its environment;
- Because of the accounting policies selected by management, the financial statements, including the note disclosures, do not faithfully represent the underlying

MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT

transactions and events in a manner that gives a true and fair view of or presents fairly, in all material respects, the information in the financial statements.

13. Where the entity has changed its selection of significant accounting policies, the auditor considers the reasons for the change and whether it is appropriate in the circumstances. Financial reporting frameworks often contain requirements for accounting for and disclosure of changes in accounting policies. Where the entity has not complied with these requirements, the auditor considers whether this constitutes a material departure from the requirements of the applicable financial reporting framework, and the effect that such departure may have on the auditor's opinion.

Application of the Selected Accounting Policies

14. Disagreements with management about the application of the selected accounting policies may arise when:
 - Management has not applied the selected accounting policies consistently with the financial reporting framework or has not applied the selected accounting policies consistently between periods and to similar transactions and events (consistency in application); or
 - Based on the audit evidence obtained, the auditor has identified a misstatement of the financial statements due to the method of application of a selected accounting policy (error in application). This may arise when there is a disagreement with management about the underlying facts and circumstances to which the selected accounting policies are applied.
15. The method of application of selected accounting policies may give rise to misstatements. [Proposed] ISA 320 (Revised), "Materiality in the Identification and Evaluation of Misstatements," provides guidance on materiality and how it is used in the identification and evaluation of misstatements when performing an audit of financial statements.

Adequacy of Disclosures in the Financial Statements

16. Disagreements with management about the adequacy of disclosures in the financial statements may arise when the financial statements (a) do not include all of the disclosures required by the applicable financial reporting framework, or (b) do not provide sufficiently clear disclosures to enable users to understand the effect of material transactions and events on the information conveyed in the financial statements, for example, in the case of financial statements prepared in accordance with International Financial Reporting Standards (IFRSs), the effect on the entity's financial position, financial performance, and cash flows.

Inability to Obtain Sufficient Appropriate Audit Evidence

17. **The auditor should express a qualified opinion when the auditor is unable to obtain sufficient appropriate audit evidence about one or more matters that are or could be material, but in the auditor's judgment are not pervasive, to the financial statements. If such matters are or could be material and pervasive to the financial statements, the auditor should express a disclaimer of opinion.**

18. The auditor's inability to obtain sufficient appropriate audit evidence may be imposed by circumstances. For example,
- When the timing of the auditor's appointment is such that the auditor is unable to observe the counting of the physical inventories;
 - When the entity's accounting records have been destroyed due to a fire.

The auditor considers whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence on which to base an unmodified opinion. If performing alternative procedures is not possible, the auditor will not be able to obtain sufficient appropriate audit evidence and, accordingly, qualifies the opinion or disclaims an opinion.

19. The auditor's inability to obtain sufficient appropriate audit evidence may also be imposed by management, for example, when management precludes the auditor from observing the counting of the physical inventory or from requesting external confirmation of specific account balances.
20. After accepting an engagement, the auditor may become aware that management has imposed a limitation on the scope of the audit which the auditor considers likely to result in the need to express a qualified opinion or a disclaimer of opinion on the financial statements. Under those circumstances, the auditor requests the removal of that limitation. If management does not remove the limitation, the auditor considers the implications for the risk assessment and whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence on which to base an unmodified opinion. If performing alternative procedures is not possible, the auditor will not be able to obtain sufficient appropriate audit evidence and, accordingly, qualifies the opinion or disclaims an opinion. When the scope limitation relates to matters that are or could be material and pervasive to the financial statements, the auditor may consider resigning from the audit, where permitted by law or regulation.

Determining the Type of Opinion

21. Where there is a disagreement with management or an inability to obtain sufficient appropriate audit evidence, the auditor determines whether a modification to the opinion is necessary and, if so, what type of opinion (a qualified opinion, an adverse opinion, or a disclaimer of opinion) is appropriate in the circumstances.
22. In deciding on the type of opinion, the auditor considers the materiality and pervasiveness of the matter giving rise to the modification to the opinion.
23. [Proposed] ISA 320 (Revised) 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.

24. 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 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 (see paragraphs 27, 29 and 32).
 - (b) Whether the effect of the disagreement with management on the financial statements can be clearly explained in the auditor's report so that the modification can address the incomplete or misleading nature of the financial statements (see paragraphs 26, 27, 29, 30 and 32).

The effect of a disagreement with management or an inability to obtain sufficient appropriate audit evidence is ordinarily considered to be pervasive when it materially affects the amounts and presentation of numerous financial statement line items. In certain circumstances, a single line item may comprise such a large percentage of the balance sheet, income statement, or cash flow statement; or otherwise be so fundamental to the financial statements taken as a whole that the auditor may conclude that a misstatement of that single line item is pervasive to the financial statements.

Qualified Opinion

25. **The auditor should express a qualified opinion when the auditor concludes that an unmodified opinion cannot be expressed, but the effect of any disagreement with management or inability to obtain sufficient appropriate audit evidence, while material, in the auditor's judgment is not pervasive to the financial statements; accordingly, neither an adverse opinion nor a disclaimer of opinion is required.** (See Example Report 1 in the Appendix for an example of a qualified opinion due to a disagreement with management and Example Reports 4 and 5 for examples of qualified opinions due to an inability to obtain sufficient appropriate audit evidence.)
26. The auditor ordinarily expresses a qualified opinion when the effect of a disagreement with management or inability to obtain sufficient appropriate audit evidence (a) can be clearly explained in the auditor's report and (b) does not result in financial statements that are misleading as a whole.
27. When a disagreement with management clearly relates to specific financial statement line items, and is readily quantifiable, for example, an overstatement of cash, revenues, or equity, the auditor will be able to clearly explain in the auditor's report the effect of the disagreement with management on the financial statements. In such situations, if the auditor concludes that the possible effect, while material, is not pervasive, the auditor ordinarily expresses a qualified opinion.

Adverse Opinion

28. **The auditor should express an adverse opinion when the auditor concludes that the effect of a disagreement with management is material and pervasive to the financial statements and accordingly, a qualified opinion is not adequate to disclose the misleading or incomplete nature of the financial statements.** (See Example Reports 2 and 3 in the Appendix.)
29. When it is not possible to determine which financial statement line items are affected or may be affected by a disagreement with management, it may be difficult or impossible for the auditor to explain in the auditor's report the effect of the disagreement with management on the financial statements. In such situations, the auditor ordinarily expresses an adverse opinion.
30. When a disagreement with management relates to multiple departures from the applicable financial reporting framework and those departures affect multiple financial statements line items, the financial statements may be misleading because of the cumulative effect of the departures. Furthermore, as the number of financial statement line items affected by the disagreements with management increases, the more difficult it becomes to clearly explain in the auditor's report the effects of the disagreements. In such situations, the auditor ordinarily expresses an adverse opinion.

Disclaimer of Opinion

31. **The auditor should express 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; accordingly, the auditor is unable to express a qualified opinion on the financial statements.** (See Example Reports 6 and 7 in the Appendix.)
32. The auditor ordinarily expresses a disclaimer of opinion when it is not possible to determine which financial statement line items are or may be affected by an inability to obtain sufficient appropriate audit evidence and accordingly it may be difficult or impossible for the auditor to clearly describe in the auditor's report the effect on the financial statements.
33. The existence of one or more significant uncertainties does not in itself result in an inability for the auditor to form an opinion. In extreme cases involving multiple uncertainties, the auditor may, however, conclude that the cumulative nature and possible effect of the multiple uncertainties are such that it is not possible to form an opinion and, accordingly, the auditor expresses a disclaimer of opinion.

Piecemeal Opinions

34. A piecemeal opinion is an opinion where the auditor expresses an adverse opinion or a disclaimer of opinion on the financial statements as a whole, but includes a supplementary unmodified opinion on one or more specific elements, accounts or line items of a financial statement. Such an opinion tends to overshadow or contradict the adverse opinion or the disclaimer of opinion and is not permitted.

Communication with Those Charged with Governance

35. **Prior to issuing the report, the auditor should communicate circumstances that lead to expected modifications to the opinion in the auditor's report to those charged with governance.** This helps to ensure that
- (a) Those charged with governance are aware of the expected modification(s) and the reasons (or circumstances) for the modification(s) before the financial statements are finalized;
 - (b) There are no disputed facts in respect of the matter(s) giving rise to the expected modification(s), or that matters of disagreement with management are confirmed as such; and
 - (c) Those charged with governance have an opportunity, where appropriate, to provide the auditor with further information and explanations in respect of the matter(s) giving rise to the expected modification(s).

Form and Content of the Auditor's Report when the Opinion is Modified

Basis for Modification Paragraph

36. Consistency in the auditor's report helps to promote the reader's understanding and to identify unusual circumstances when they occur. Accordingly, 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.
37. ISA 700 (Revised) and ISA 800 require the auditor to include certain specific elements in the auditor's report when the auditor's opinion is unmodified. **In addition to those specific elements, whenever the auditor expresses a modified opinion on the financial statements, the auditor should include a paragraph that provides:**
- (a) **A clear description of all the substantive reasons for the modification;**
 - (b) **In the event of a disagreement with management about disclosures, a description of the omitted disclosures, unless impracticable or prohibited by law or regulation.** It is not impracticable when the omitted disclosure information is reasonably available, and providing the information in the auditor's report does not require the auditor to assume management's responsibility for the preparation of the financial statements. For example, it is not impracticable if the information can be obtained from the accounting records without the auditor (i) substantially increasing the effort that would normally be required to complete the audit, and (ii) assuming management's responsibility for preparing the financial statements. In those cases, the auditor includes the omitted information in the basis for modification paragraph of the auditor's report;
 - (c) **In the event of a disagreement with management, a description and quantification of the principal effects on the financial statements of the matter**

giving rise to the modification, unless impracticable. If the principal effects are not reasonably quantifiable, the auditor's report should so state.

- (d) **In the event of an inability to obtain sufficient appropriate audit evidence, a description of the reason for the inability.** (See paragraphs 17-20)

This paragraph should precede the opinion paragraph in the auditor's report and should have the heading "Basis for Qualified Opinion," Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate.

38. If the modification arises from a known or likely misstatement (see [proposed] ISA 320 (Revised)), the consequences of the misstatement are described in the basis for modification paragraph. For example, if inventory is overstated, tax, net income and equity will be affected as a consequence. When there is an inability to obtain sufficient appropriate audit evidence, the auditor may not be able to quantify the possible effects on the financial statements, and thus may not be able to include such information in the basis for modification paragraph.
39. The auditor describes in the basis for modification paragraph of the auditor's report the reasons for all matters that require modifications to the opinion, and the effects thereof. For example, even when the auditor expresses an adverse opinion because the auditor concludes that the entity is not a going concern, the adverse opinion does not justify the omission of specific modifications for specific disagreements with management about the recognition, measurement, or disclosure of certain assets and liabilities, for example, the existence of inventory.

Opinion Paragraph

40. **When the opinion is modified, the opinion paragraph should have the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate.** Inclusion of this paragraph heading makes it clear to the user that the auditor's opinion is modified and the type of modification.
41. **When expressing a qualified opinion, the opinion paragraph should state that, in the auditor's opinion, except for the effect of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view (or "present fairly, in all material respects") in accordance with the applicable financial reporting framework. When the modification arises from an inability to obtain sufficient appropriate audit evidence, the opinion should use the phrase "except for the possible effect of the matter..."** Other phrases such as "with the foregoing explanation" or "subject to" are not sufficiently clear or forceful and are not used.
42. **When expressing an adverse opinion, the opinion paragraph should state that, in the auditor's opinion, because of the significance of the matters described in the Basis for Adverse Opinion paragraph, the financial statements do not give a true and fair view (or "present fairly, in all material respects") in accordance with the applicable financial reporting framework.**

43. **When expressing a disclaimer of opinion, the opinion paragraph should state that, in the auditor's opinion, because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion and, accordingly, the auditor does not express an opinion on the financial statements.**

Description of Auditor's Responsibility when there is an Inability to Obtain Sufficient Appropriate Audit Evidence

44. **When the auditor expresses a qualified opinion because of an inability to obtain sufficient appropriate audit evidence, the auditor should amend the description of the auditor's responsibility to state that, except for the matter described in the Basis for Qualified Opinion paragraph, the auditor conducted the audit in accordance with ISAs.**
45. **When the auditor expresses a disclaimer of opinion, the auditor should amend the description of the auditor's responsibility and the description of the scope of the audit to state only that, because of the matter(s) described in the Basis for Disclaimer paragraph, the auditor was not able to complete an audit in accordance with ISAs.**

Effective Date

46. **This ISA is effective for auditors' reports dated on or after December 31, 2006.**

Appendix

Examples of Auditors' Reports with Modifications to the Opinion

Example Report 1: Auditor's report with a qualified opinion due to a disagreement with management – overstatement of inventories; the effect of this disagreement with management is deemed to be material but not pervasive to the financial statements. The report also contains an emphasis of matter paragraph (see [proposed] ISA 706, "Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report").

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements⁴

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and the fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit

⁴ The subheading "Report on the Financial Statements" is unnecessary in circumstances when the second subheading "Report on Other Legal and Regulatory Requirements" is not applicable.

procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.⁵ An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Basis for Qualified Opinion

The company's inventories are recognized in the balance sheet at 16 million EUR. Based on the audit evidence obtained, we believe that an adjustment to inventories of 5 million EUR is required to recognize slow-moving items at their net realizable value. The tax effect of this adjustment is 1.5 million EUR. Accordingly, we believe that shareholders' equity and profit for the year are overstated by 3.5 million EUR respectively.

Qualified Opinion

In our opinion, except for the effects of the matters described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of (or "present fairly, in all material respects") the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Emphasis of Matter

We draw attention to a significant and unusual related party transaction disclosed in Note X to the financial statements, which includes an appropriate description of the company's sale of the office equipment division to a member of the company's management team for 100 million EUR.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

⁵ In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances."

Example Report 2: Auditor's report with an adverse opinion due to a disagreement with management related to the going concern assumption; the effect of the disagreement with management is deemed to be material and pervasive to the financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements⁶

We have audited ... *(remaining words are the same as illustrated in the introductory paragraph – see Example Report 1 above).*

Management's Responsibility for the Financial Statements

Management is responsible for ... *(remaining words are the same as illustrated in the management's responsibility paragraph – see Example Report 1 above).*

Auditor's Responsibility

Our responsibility is ... *(remaining words are the same as illustrated in the paragraphs describing the auditor's responsibility – see Example Report 1).*

Basis for Adverse Opinion

As discussed in Note X to the financial statements, ABC Company's financing arrangements expired and the amount outstanding was payable on December 31, 20X1. The company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. Based on the audit evidence obtained, we believe that the company will not be able to meet its obligations in the ordinary course of business. Accordingly, we do not agree with management's preparation and presentation of the financial statements on a going concern basis. Had the financial statements been prepared on a liquidation basis of accounting, we believe that it would have had a significant negative effect on the company's financial position and financial performance.

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the financial statements do not give a true and fair view of *(or "present fairly, in all material respects")* the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

⁶ The subheading "Report on the Financial Statements" is unnecessary in circumstances when the second subheading "Report on Other Legal and Regulatory Requirements" is not applicable.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Example Report 3: Auditor's report with an adverse opinion due to a disagreement with management related to the write-down of accounts receivable in the amount of 5 million EUR; the balance sheet total is 7 million EUR and the profit after tax is 0.3 million EUR. The effect of this disagreement with management is deemed to be both material and pervasive to the financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements⁷

We have audited ... *(remaining words are the same as illustrated in the introductory paragraph – see Example Report 1 above).*

Management's Responsibility for the Financial Statements

Management is responsible for ... *(remaining words are the same as illustrated in the management's responsibility paragraph – see Example Report 1 above).*

Auditor's Responsibility

Our responsibility is ... *(remaining words are the same as illustrated in the paragraphs describing the auditor's responsibility – see Example Report 1).*

Basis for Adverse Opinion

The company's accounts receivable are recognized in the balance sheet at 6 million EUR. Based on the audit evidence obtained, we believe an adjustment to accounts receivable of 5 million EUR is required to recognize a receivable from XYZ Company that cannot be collected. The tax effect is 1.5 million EUR. Accordingly, we believe that shareholders' equity and profit for the year are overstated by 3.5 million EUR respectively.

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the financial statements do not give a true and fair view of *(or "present fairly, in all material respects")* the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

⁷ The subheading "Report on the Financial Statements" is unnecessary in circumstances when the second subheading "Report on Other Legal and Regulatory Requirements" is not applicable.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Example Report 4: Auditor's report with a qualified opinion due to the auditor's inability to obtain sufficient appropriate audit evidence regarding an investment in a foreign affiliate; the possible effect of the inability to obtain sufficient appropriate audit evidence can be clearly described in the auditor's report and, while material, is not deemed to be pervasive to the financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements⁸

We have audited ... *(remaining words are the same as illustrated in the introductory paragraph – see Example Report 1 above).*

Management's Responsibility for the Financial Statements

Management is responsible for ... *(remaining words are the same as illustrated in the management's responsibility paragraph – see Example Report 1 above).*

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. Except for the matter described in the Basis for Qualified Opinion paragraph, we conducted our audit ... *(remaining words of the first two paragraphs are the same as in the first two paragraphs of the auditor's responsibility – see Example Report 1 above).*

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Basis for Qualified Opinion

ABC Company's investment in XYZ Company, a foreign associate accounted for by the equity method, is recognized at 15 million EUR on the balance sheet as at December 31, 20X1, and ABC's share of profit of XYZ Company is recognized at 1 million EUR in the income statement for the year ended December 31, 20X1. We were unable to obtain sufficient appropriate audit evidence in relation to the financial information of XYZ Company because we were unable to obtain access to the accounting records, management, or auditor of XYZ Company.

Qualified Opinion

In our opinion, except for the possible effects of the matters described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of *(or "present fairly, in all material respects")* the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

⁸ The subheading "Report on the Financial Statements" is unnecessary in circumstances when the second subheading "Report on Other Legal and Regulatory Requirements" is not applicable.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Example Report 5: Auditor's report with a qualified opinion due to the auditor's inability to obtain sufficient appropriate audit evidence; the possible effect of the inability to obtain sufficient appropriate audit evidence can be clearly described in the auditor's report and, while material, is not deemed to be pervasive to the financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements⁹

We have audited ... *(remaining words are the same as illustrated in the introductory paragraph – see Example Report 1 above).*

Management's Responsibility for the Financial Statements

Management is responsible for ... *(remaining words are the same as illustrated in the management's responsibility paragraph – see Example Report 1 above).*

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. Except for the matter described in the Basis for Qualified Opinion paragraph, we conducted our audit ... *(remaining words of the first two paragraphs are the same as in the first two paragraphs of the auditor's responsibility – see Example Report 1 above)*

We believe that the audit evidence that we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Basis for Qualified Opinion

The company's accounting records for cash sales were not adequate for purposes of our audit and therefore there were no satisfactory audit procedures that we could perform to obtain reasonable assurance that all cash sales have been properly recorded. The company's recorded sales, which total 1 million EUR, include 50,000 EUR in cash sales.

Qualified Opinion

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of *(or "present fairly, in all material respects")* the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards

⁹ The subheading "Report on the Financial Statements" is unnecessary in circumstances when the second subheading "Report on Other Legal and Regulatory Requirements" is not applicable.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Example Report 6: Auditor's report with a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence with respect to inventory and accounts receivable; the auditor was unable to obtain sufficient appropriate audit evidence because management restricted the scope of the auditor's procedures; the report also identifies a disagreement with management related to interest-bearing borrowings; the possible effect of the inability to obtain sufficient appropriate audit evidence is deemed to be material and pervasive to the financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements¹⁰

We were engaged to audit the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for ... *(remaining words are the same as illustrated in the management's responsibility paragraph – see Example Report 1 above).*

Auditor's Responsibility

Because of the matter described in the Basis for Disclaimer of Opinion paragraph, we were not able to complete an audit in accordance with International Standards on Auditing.

Basis for Disclaimer of Opinion

The company's management restricted us from observing the counting of the physical inventories and sending out requests for confirmation of accounts receivable to certain customers. The company's records did not permit the application of alternative auditing procedures regarding the inventories and accounts receivable. Consequently, we were unable to obtain all the information and explanations we considered necessary to satisfy ourselves as to the existence of inventories and accounts receivable.

Furthermore, included in interest bearing borrowings, under non-current liabilities, are amounts totaling 5 million EUR that are due for settlement within the forthcoming fiscal year. International Accounting Standard 1, "Presentation of Financial Statements," requires separate disclosure of amounts that are to be settled before and after the forthcoming fiscal year. Based on the latter, interest-bearing

¹⁰ The subheading "Report on the Financial Statements" is unnecessary in circumstances when the second subheading "Report on Other Legal and Regulatory Requirements" is not applicable.

MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT

borrowings would have been stated at 15 million EUR, short-term borrowings at 10 million EUR and current liabilities at 25 million EUR.

Disclaimer of Opinion

Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraphs above, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Example Report 7: Auditor's report with a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence; completeness of accounting records cannot be substantiated due to lack of control over sales; the possible effect of this inability to obtain sufficient appropriate audit evidence is deemed to be material and pervasive to the financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements¹¹

We were engaged to audit the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for ... *(remaining words are the same as illustrated in the management's responsibility paragraph – see Example Report 1 above).*

Auditor's Responsibility

Because of the matter described in the Basis for Disclaimer of Opinion paragraph, we were not able to complete an audit in accordance with International Standards on Auditing.

Basis for Disclaimer of Opinion

The Company's sales are made entirely on a cash basis. The Company's accounting records for cash sales were not adequate for the purposes of our audit and, therefore, there were no satisfactory audit procedures that we could perform to obtain reasonable assurance that all cash sales have been properly recorded.

Disclaimer of Opinion

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

¹¹ The subheading "Report on the Financial Statements" is unnecessary in circumstances when the second subheading "Report on Other Legal and Regulatory Requirements" is not applicable.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

PROPOSED INTERNATIONAL STANDARD ON AUDITING 706
EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTERS
PARAGRAPHS IN THE INDEPENDENT AUDITOR’S REPORT

(Effective for auditors’ reports dated on or after
December 31, 2006)

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International Standard on Auditing (ISA) 706, “Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor’s Report,” should be read in the context of the Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services,” which sets out the application and authority of ISAs.

Introduction

1. This International Standard on Auditing (ISA) establishes standards and provides guidance on circumstances when the auditor includes an emphasis of matter paragraph (see paragraphs 6–16) or considers including an other matters paragraph (see paragraphs 17-21) in the auditor's report on the financial statements, and on the form and placement of such paragraphs.
2. ISA 700 (Revised), "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements," establishes standards and provides guidance on the form and content of the auditor's report on a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation when the auditor is able to express an unmodified opinion.
3. ISA 800, "The Independent Auditor's Report on Special Purpose Audit Engagements," establishes standards and provides guidance on the independent auditor's report issued as a result of:
 - (a) A complete set of financial statements prepared in accordance with an other comprehensive basis of accounting;
 - (b) A component of a complete set of general purpose or special purpose financial statements, such as a single financial statement, specified accounts, elements of accounts, or items in a financial statement;
 - (c) Compliance with contractual agreements; and
 - (d) Summarized financial statements.¹
4. Both ISA 700 (Revised) and ISA 800 address circumstances when the auditor is able to express an unmodified opinion and no other changes to the auditor's report are necessary. [Proposed] ISA 705, "Modifications to the Opinion in the Independent Auditor's Report," establishes standards and provides guidance for auditors' reports issued in accordance with ISA 700 (Revised) and ISA 800 when the auditor's opinion is modified.
5. The standards and guidance in this ISA are to be applied in circumstances when the auditor includes an emphasis of matter paragraph or an other matters paragraph in an auditor's report issued in accordance with ISA 700 (Revised), ISA 800 and [proposed] ISA 705. The illustrative reports in this ISA (see Appendix) are based on the form and content of the auditor's report on a complete set of general purpose financial statements.

¹ The IAASB is currently revising ISA 800 to expand its scope to cover auditors' reports on historical financial information other than a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation, which is covered in ISA 700 (Revised). The proposed ISA 705 applies to engagements that fall within ISA 700 (Revised) and those that will fall within the proposed revised ISA 800. On finalization of the proposed revised ISA 800 (expected to be exposed for public comment later this year), this paragraph will be amended to conform to ISA 800 (Revised).

Emphasis of Matter Paragraph in the Auditor's Report

6. **The auditor should emphasize in the auditor's report a matter in the financial statements when, in the auditor's judgment, both of the following conditions are met:**
 - (a) **The matter is of fundamental importance to the user's understanding of the financial statements, and**
 - (b) **The matter is unusual.**
7. Ordinarily the auditor determines a matter to be of fundamental importance to the user's understanding of the financial statements if the consequences or possible consequences of the matter could significantly affect the entity's financial position, financial performance or cash flows.
8. The auditor ordinarily considers a matter to be unusual if it occurs infrequently or is out of the ordinary course of business for the entity or for other entities in the industry.
9. 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 either the auditor's expression of a qualified opinion, an adverse opinion, or a disclaimer of opinion when required by the circumstances of a specific audit engagement (see [proposed] ISA 705), or disclosures in the financial statements that the applicable financial reporting framework requires management to make.
10. 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 a qualified opinion or an adverse opinion is appropriate (see [proposed] ISA 705 (Revised)).

11. ISA 570, "Going Concern," requires the auditor to include an emphasis of matter paragraph in the auditor's report to highlight the existence of a material uncertainty regarding an entity's ability to continue as a going concern. The auditor draws attention to the disclosure in the financial statements that discusses the going concern uncertainty.
12. Other circumstances in which the auditor includes an emphasis of matter paragraph when the criteria in paragraphs 6 and 10 are met include the following:
 - Significant uncertainties such as an uncertainty related to the future outcome of major litigation or regulatory action (for example, a regulatory agency requires a company to recall a major product for safety reasons) (see Example Report 1 in the Appendix);

EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTERS
PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT

- Significant and unusual related party transactions (see Example Report 2 in the Appendix);
 - Early application of a new accounting principle (or International Financial Reporting Standard) (that is, 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 (see Example Report 3 in the Appendix).
13. Significant uncertainties about the outcome of future events may affect a number of financial statement line items. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made, and making the required disclosures in accordance with the applicable financial reporting framework.
14. When one or more uncertainties meet the requirements of paragraphs 6 and 10, the auditor includes an emphasis of matter paragraph in the auditor's report. The existence of one or more significant uncertainties does not in itself result in an inability for the auditor to form an opinion. A significant uncertainty can be expected to be resolved at a future date, at which time conclusive information concerning its outcome will become available. Consequently, a lack of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the information supporting management's assertions is not sufficient. Rather, the auditor's judgment regarding the sufficiency of appropriate audit evidence is based on information that is, or should be, available. If, after considering the existing conditions and available information, the auditor concludes that sufficient appropriate audit evidence supports management's assertions and related disclosures about an uncertainty and its presentation and disclosure in the financial statements, the auditor expresses an unmodified opinion.
15. The auditor may decide to include an emphasis of matter paragraph regarding the disclosure of significant and unusual related party transactions in order to highlight the potential effect of the relationship on the financial statements as described in the disclosure.
16. **An emphasis of matter paragraph should follow the opinion paragraph in the auditor's report and should have a heading that indicates that it deals with an emphasis of matter, that is, "Emphasis of Matter." The emphasis of matter paragraph should clearly describe the matter being emphasized.** The auditor draws attention to the disclosure in the financial statements that discusses the matter. The auditor does not make disclosures in the emphasis of matter paragraph beyond those included in the financial statements because doing so may imply that the criteria in paragraph 10 are not met.

Other Matters Paragraph in the Auditor's Report

17. In some jurisdictions, the auditor's report may be the only means of communicating to readers of the report. As a result, the auditor may find it necessary to use the auditor's report as a means of communicating information relating to matters other than those that are required to be presented or disclosed in the financial statements and thus the subject of an emphasis of matter paragraph. Such information is referred to in this ISA as "Other Matters."
18. **The auditor should include other matters in a separate paragraph of the auditor's report with a heading that indicates that it deals with an other matter, that is, "Other Matters."** This other matters paragraph ordinarily follows the auditor's opinion and any emphasis of matter paragraph. (See Example Report 1 in the Appendix.)
19. 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.
20. The other matters paragraph addresses only 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 that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon that the auditor may be required or permitted to elaborate on by standards, laws, or generally accepted practice in a jurisdiction. (See paragraph 45 of ISA 700 (Revised).)
 - (c) In rare and unusual circumstances, other matters that the auditor considers relevant to communicate to the user.
21. As described in ISA 720, "Other Information in Documents Containing Audited Financial Statements," the auditor has a responsibility to read the other information in a document containing audited financial statements to identify material inconsistencies or misleading information. ISA 720 provides guidance for the auditor when an amendment to such other information is necessary for it not to be materially inconsistent with the information in the financial statements and management refuses to make the amendment. If an amendment is necessary in the other information and management refuses to make the amendment, the auditor considers including in the auditor's report an other matters paragraph describing the material inconsistency or taking other actions.

Effective Date

22. This ISA is effective for auditor's reports dated on or after December 31, 2006.

Examples of Auditors' Reports that Include Emphasis of Matter Paragraphs or Other Matters Paragraphs

Example Report 1: Auditor's report with an unmodified opinion; the report contains an emphasis of matter paragraph referring to a significant uncertainty related to pending litigation and an other matters paragraph referring to a material inconsistency with other information in the annual report containing audited financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements²

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and the fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of

² The subheading "Report on the Financial Statements" is unnecessary in circumstances when the second subheading "Report on Other Legal and Regulatory Requirements" is not applicable.

EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTERS
PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT

expressing an opinion on the effectiveness of the entity's internal control.³ An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence that we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements give a true and fair view of (*or "present fairly, in all material respects"*) the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Emphasis of Matter

We draw attention to Note X to the financial statements, which appropriately describes the significant uncertainty related to the outcome of a lawsuit in which the company is the defendant. The lawsuit alleges infringement of certain patent rights and claims royalties and punitive damages in the amount of 10 million EUR. Although the company acknowledges that there is significant uncertainty related to the outcome of the lawsuit, the company believes that it will be able to successfully defend its case and, accordingly, no provision for any liability that may result has been recognized in the financial statements.

Other Matters

In the Chairman's Report contained in the Annual Report, it is stated that the company has realized a relative increase in profitability this year over that of the prior year. While this statement is consistent with regard to earnings before interest, taxes, depreciation, and amortization (EBITDA), it is inconsistent with regard to profit for the year, which has decreased from last year.

Report on Other Legal and Regulatory Requirements (ISA 700 (Revised), paragraphs 46-49)

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

³ In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances."

EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTERS
PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT

Example Report 2: Auditor's report with an unmodified opinion; the report contains an emphasis of matter paragraph referring to a significant and unusual related party transaction.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements⁴

We have audited ... *(remaining words are the same as illustrated in the introductory paragraph – see Example Report 1 above).*

Management's Responsibility for the Financial Statements

Management is responsible for ... *(remaining words are the same as illustrated in the management's responsibility paragraph – see Example Report 1 above).*

Auditor's Responsibility

Our responsibility is ... *(remaining words are the same as illustrated in the auditor's responsibility paragraphs – see Example Report 1 above).*

Opinion

In our opinion ... *(remaining words are the same as illustrated in the opinion paragraph – see Example Report 1 above).*

Emphasis of Matter

We draw attention to a significant and unusual related party transaction disclosed in Note X to the financial statements, which includes an appropriate description of the company's sale of the office equipment division to a member of the company's management team for 100 million EUR.

Report on Other Legal and Regulatory Requirements (ISA 700 (Revised), paragraphs 46-49)

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

⁴ The subheading "Report on the Financial Statements" is unnecessary in circumstances when the second subheading "Report on Other Legal and Regulatory Requirements" is not applicable.

EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTERS
PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT

Example Report 3: Auditor's report with an unmodified opinion; the report also contains an emphasis of matter paragraph referring to uncertainty regarding the effects of a major catastrophe.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements⁵

We have audited ... *(remaining words are the same as illustrated in the introductory paragraph – see Example Report 1 above).*

Management's Responsibility for the Financial Statements

Management is responsible for... *(remaining words are the same as illustrated in the management's responsibility paragraph – see Example Report 1 above).*

Auditor's Responsibility

Our responsibility is ... *(remaining words are the same as illustrated in the auditor's responsibility paragraphs – see Example Report 1 above).*

Opinion

In our opinion ... *(remaining words are the same as illustrated in the opinion paragraph – see Example Report 1 above).*

Emphasis of Matter

We draw attention to Note X to the financial statements, which includes an appropriate description of the considerable uncertainties to which the calculation of the year's results and shareholders' equity at December 31, 20X1 are subject because of [*describe major catastrophe*]. Note X further gives a description of the fact that the company is in the process of restructuring due to the catastrophe, and a description of the related accounting treatment, including expectations for the company's future operations.

Report on Other Legal and Regulatory Requirements (ISA 700 (Revised), paragraphs 46-49)

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

⁵ The subheading "Report on the Financial Statements" is unnecessary in circumstances when the second subheading "Report on Other Legal and Regulatory Requirements" is not applicable.

PROPOSED CONFORMING AMENDMENTS

ISA 200, “Objective and General Principles Governing an Audit of Financial Statements”

42. In some jurisdictions, legislative and regulatory requirements may supplement a 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 disclosures. If this is not possible, the auditor considers whether it is necessary to modify the opinion in the auditor’s report, see ISA ~~704~~ 705, “Modifications to the Opinion in the Independent Auditor’s Report.”
48. 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 (see ISA 210) and the auditor’s report (see ISA ~~704~~ 705).
49. When the auditor is expressing an opinion on a complete set of general purpose financial statements prepared in accordance with a financial reporting framework that is designed to achieve fair presentation, the auditor refers to ISA 700, “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements,” for standards and 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 ~~704~~ 5 when expressing modified ~~audit~~ opinion, including an ~~emphasis of matter~~, a qualified opinion, a disclaimer of opinion or an adverse opinion, and to ISA 706, “Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor’s Report,” when including an emphasis of matter paragraph or an other matters paragraph in the auditor’s report.

ISA 210, “Terms of Audit Engagements”

The reference to ISA 701, “Modifications to the Independent Auditor’s Reports” in paragraphs 14 and 15 will be changed to ISA 705, “Modifications to the Opinion in the Independent Auditor’s Report.” The reference to paragraph 5 of ISA 701 in paragraph 14 will be deleted.

ISA 240, “The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements”

89. **When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor should consider**

the implications for the audit. ISA 320, “Audit Materiality” and ~~ISA 700, “The Auditor’s Report on Financial Statements”~~ ISA 705, “Modifications to the Opinion in the Independent Auditor’s Report” provide guidance on the evaluation and disposition of misstatements and the effect on the opinion in the auditor’s report. (The footnote reference in this paragraph will also be deleted.)

ISA 560, “Subsequent Events”

The reference to ISA 701, “Modifications to the Independent Auditor’s Reports” in paragraph 11 will be changed to ISA 705, “Modifications to the Opinion in the Independent Auditor’s Report.”

A reference to ISA 706, “Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor’s Report” will be inserted in paragraph 16.

ISA 570, “Going Concern”

33. **If adequate disclosure is made in the financial statements, the auditor should express an ~~unqualified~~ unmodified opinion but ~~modify~~ include an emphasis of matter paragraph in the auditor’s report by adding an emphasis of matter paragraph that highlight 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. (See ISA 706, “Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor’s Report.”) In evaluating the adequacy of the financial statement disclosure, the auditor considers whether the information explicitly draws the reader’s attention to the possibility that the entity may be unable to continue realizing its assets and discharging its liabilities in the normal course of business. The following is an example of such a paragraph when the auditor is satisfied as to the adequacy of the note disclosure:**

~~“Without qualifying our opinion, w~~We draw attention to Note X in the financial statements which indicates that the Company incurred a net loss of ZZZ during the year ended December 31, 20X1 and, as of that date, the Company’s current liabilities exceeded its total assets by ZZZ. These conditions, along with other matters as set forth in Note X, indicate the existence of a material uncertainty which may cast significant doubt about the Company’s ability to continue as a going concern.”

In extreme cases, such as situations involving multiple material uncertainties that are significant to the financial statements, the auditor may consider it appropriate to express a disclaimer of opinion instead of adding an emphasis of matter paragraph.

36. When the entity’s management has concluded that the going concern assumption used in the preparation of the financial statements is not appropriate, the financial statements need to be prepared on an alternative authoritative basis. If on the basis of the additional audit procedures carried out and the information obtained the auditor determines the alternative basis is appropriate, the auditor can issue an ~~unqualified~~ unmodified opinion if there is adequate disclosure but ~~may require~~ the auditor includes an emphasis of matter paragraph in the auditor’s report to draw the user’s attention to that basis (see ISA 706).

37. **If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor should consider the need to modify the opinion in the auditor’s report as a result of the ~~limitation on the scope of the auditor’s work~~ auditor’s inability to obtain sufficient appropriate audit evidence.** In certain circumstances, such as those described in paragraphs 15, 18 and 24, the auditor may believe that it is necessary to ask management to make or extend its assessment. If management is unwilling to do so, it is not the auditor’s responsibility to rectify the lack of analysis by management, and a ~~modified report~~ qualified opinion or a disclaimer of opinion in the auditor’s report may be appropriate because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding the use of the going concern assumption in the preparation of the financial statements.

The reference to ISA 701, “Modifications to the Independent Auditor’s Reports” in paragraph 38 will be changed to ISA 705, “Modifications to the Opinion in the Independent Auditor’s Report.”

ISA 700 (Revised), “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements”

Introduction

2. This ISA addresses circumstances when the auditor is able to express an unmodified ~~unqualified~~ opinion and no modification to the auditor’s report is necessary. ISA ~~701~~ 705, “Modifications to the Opinion in the Independent Auditor’s Report” establishes standards and provides guidance on ~~the modifications to this report for an emphasis of matter, a qualified opinion, a disclaimer of opinion, or an adverse opinion~~ (a) circumstances that may result in a modification to 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. ISA 706, “Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor’s Report,” establishes standards and provides guidance on circumstances when the auditor includes an emphasis of matter paragraph or considers including an other matters paragraph in the auditor’s report on the financial statements.

The reference to ISA 701 in paragraphs 8 and 15 will be changed to ISA 705. A reference to ISA 706 will be inserted in paragraph 45. The reference to ISA 701 in paragraph 63 will be changed to ISA 570, “Going Concern, paragraph 33.

ISA 710, “Comparatives”

Corresponding Figures

Reporting

12. When the auditor’s report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is:
 - Unresolved, and results in a ~~modification of the~~ modified opinion in the auditor’s report regarding the current period figures, the opinion in the auditor’s report should also be modified regarding the corresponding figures; or
 - Unresolved, but does not result in a modification of the opinion in the auditor’s report regarding the current period figures, the opinion in the auditor’s report should be modified regarding the corresponding figures.
13. When the auditor’s report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the ~~modification~~ modified opinion 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.
15. In such circumstances, the auditor should consider the guidance in ISA 560, “Subsequent Events” and:
 - (a) If the prior period financial statements have been revised and reissued with a new auditor’s report, the auditor should obtain sufficient appropriate audit evidence that the corresponding figures agree with the revised financial statements; or
 - (b) If the prior period financial statements have not been revised and reissued, and the corresponding figures have not been properly restated and/or appropriate disclosures have not been made, the auditor should ~~issue a modified~~ express a qualified opinion or an adverse opinion in the auditor’s report on the current period financial statements, modified with respect to the corresponding figures included therein.
16. If, in the circumstances described in paragraph 14, the prior period financial statements have not been revised and an auditor’s report has not been reissued, but the corresponding figures have been properly restated and/or appropriate disclosures have been made in the current period financial statements, the auditor may include an ~~emphasis of matter~~ other matters paragraph describing the circumstances and referencing to the appropriate disclosures (see ISA 706). In this regard, the auditor also considers the guidance in ISA 560.

Incoming Auditor—Additional Requirements

Prior Period Financial Statements Audited by Another Auditor

17. In some jurisdictions, the incoming auditor is permitted to refer to the predecessor auditor's report on the corresponding figures in the incoming auditor's report for the current period. **When the auditor decides to refer to another auditor, the incoming auditor's report should indicate:**
- (a) **That the financial statements of the prior period were audited by another auditor;**
 - (b) **The type of opinion expressed by the predecessor auditor and, if the report opinion was modified, the reasons therefor; and**
 - (c) **The date of that report.**
- ~~19. In situations where the incoming auditor identifies that the corresponding figures are materially misstated, the auditor should request management to revise the corresponding figures or if management refuses to do so, appropriately modify the report.~~

Reporting

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 opinion or an adverse opinion, disclaim an opinion, or include an emphasis of matter paragraph or other matters paragraph with respect to one or more financial statements for one or more periods, while issuing a different report on the other financial statements.
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~~ other matters paragraph (see ISA 706).** 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.

Incoming Auditor—Additional Requirements

Prior Period Financial Statements Audited by Another Auditor

26. **When the financial statements of the prior period were audited by another auditor:**
- (a) **The predecessor auditor may reissue the auditor's report on the prior period with the incoming auditor only reporting on the current period; or**
 - (b) **The incoming auditor's report should state that the prior period was audited by another auditor and the incoming auditor's report should indicate:**

PROPOSED CONFORMING AMENDMENTS

- (i) That the financial statements of the prior period were audited by another auditor;
 - (ii) The type of ~~report~~ opinion expressed by the predecessor auditor and if the ~~report~~ opinion was modified, the reasons therefor; and
 - (iii) The date of that report.
31. ~~In situations where the incoming auditor identifies that the prior year unaudited figures are materially misstated, the auditor should request management to revise the prior year's figures or if management refuses to do so, appropriately modify the report.~~

ISA 720, “Other Information in Documents Containing Audited Financial Statements”

- 12. If an amendment is necessary in the audited financial statements and the entity refuses to make the amendment, the auditor should express a qualified opinion or an adverse opinion.
- 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~~ other matters paragraph describing the material inconsistency (see ISA 706, “Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor’s Report”) or taking other actions. The actions taken, such as not issuing the auditor’s report or withdrawing from the engagement, will depend upon the particular circumstances and the nature and significance of the inconsistency. The auditor would also consider obtaining legal advice as to further action.



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