

IAASB CAG PAPER



International Federation of Accountants

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Agenda Item

F

Committee: IAASB Consultative Advisory Group

Meeting Location: Paris

Meeting Date: May 11-12, 2006

Modifications

Objectives of Agenda Item

1. To receive a report on the IAASB's response to the significant comments received from respondents to the exposure drafts of proposed ISA 705, "Modifications to the Opinion in the Independent Auditor's Report," and proposed ISA 706, "Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor's Report," and the task force's recommendations for the "close off" versions of the proposed ISAs.
2. To receive a report on significant issues raised by the IAASB CAG in December and how the task force and the IAASB have responded to them.

CAG Papers Presented

Agenda Item F.1 summarizes the task force's response to the significant comments received on exposure and the issues raised by the IAASB CAG in December. Agenda Item F summarizes the IAASB's response to the comments received on exposure and from the IAASB CAG, and includes the task force's recommendations for the "close off" versions of the proposed ISAs.

Task Force Activities to Date

The exposure period closed on July 31, 2005 and a total of 40 comment letters were received. The IAASB discussed the significant comments received on the exposure drafts at its March meeting. The task force met in April to consider the input received from the IAASB and to finalize the wording of the "close off" versions of the proposed ISAs.

Significant Exposure Draft Comments Discussed by the IAASB

Proposed ISA 705

1. DESCRIPTION OF PERVASIVENESS IN RELATION TO MISSTATEMENTS

At the March IAASB meeting, the IAASB considered the significant comments received on exposure and at the December 2005 IAASB CAG meeting regarding the proposed description of "pervasiveness" (*Issue B1 in Agenda Item F.1*). The task force proposed to describe the meaning of a pervasive disagreement with management in terms of whether the disagreement affects the financial statements to such an extent that they become misleading as a whole. The IAASB recommended that the term "disagreement with management" be replaced with the broader term "material misstatement," since it is possible to have a situation where management agrees with the auditor that the financial statements are misstated but management refuses to correct them.

IAASB CAG PAPER

IAASB CAG Agenda (May 2006)

Agenda Item F

Modifications—Significant Comments on Proposed ISAs 705 & 706

The appropriateness of linking the determination of the pervasiveness of a misstatement with whether it has a misleading effect on the financial statements as a whole, was questioned. It was noted that there could be some situations where a material misstatement might cause the financial statements to be misleading but a qualified opinion would still be adequate. In addition, it was noted that the proposed footnote reference to the IFAC Code of Ethics for the term “misleading” only dealt with the auditor’s ethical responsibilities and did not really explain the meaning of “misleading.”

Some IAASB members asked the task force to consider defining the meaning of “misleading.” The task force gave this due consideration and decided that it would be inappropriate to focus narrowly on interpreting this term for the specific purposes of this ISA, as the term is also used in a number of other ISAs. Further, a definition of “misleading” would likely need to include an explanation of how the term interrelates with the concept of freedom from material misstatement for the financial statements as a whole (as addressed in ISA 200, “Objective and General Principles Governing an Audit of Financial Statements”). This would thus take the issue outside the scope of this project. The task force therefore thought it would be more appropriate to entrust another project (with a broader scope) with the task of establishing a definition of “misleading” that would apply consistently across all ISAs that use the term.

The task force also decided to revise the description of pervasiveness regarding the effects of a misstatement (or a combination of misstatements) in terms of whether they affect the financial statements to such an extent that the financial statements, taken as a whole, are not prepared in accordance with the applicable financial reporting framework. This links the determination of pervasiveness directly to the main objective of the audit as set out in ISA 200, i.e. to enable the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. The task force noted that this approach would clearly enable the auditor to differentiate between the effects of a misstatement that are merely material from those that are pervasive. This is because in the case of those effects of a misstatement that are material but not pervasive, the auditor would still be able to conclude that, except for the effects of the misstated element, account or item in the financial statements, the rest of the financial statements has been properly prepared in accordance with the applicable financial reporting framework. When the effects of the misstatement are pervasive, however, the entire financial statements are affected, and thus the auditor cannot conclude on any part of the financial statements with regard to proper preparation in accordance with the framework. This approach is set out in **paragraph 9 of the close-off draft (Agenda Item F.2).**

Matter for Consideration by the IAASB CAG:

1. What are the Representatives’ views on the task force’s proposed approach to explaining the meaning of pervasiveness in relation to the effects of misstatements?

2. CRITERIA FOR PERVASIVENESS IN RELATION TO MISSTATEMENTS

IAASB CAG PAPER

IAASB CAG Agenda (May 2006)

Agenda Item F

Modifications—Significant Comments on Proposed ISAs 705 & 706

The draft of ISA 705 discussed at the March IAASB meeting proposed guidance to assist the auditor in determining whether a qualified or adverse opinion would be appropriate in terms of whether the effects of the material misstatement could be clearly explained in the auditor's report. A number of IAASB members pointed out that this criterion was somewhat unsatisfactory in that it did not clearly differentiate between material and pervasive situations. The task force reconsidered the guidance and decided to replace this criterion with criteria for pervasiveness in terms of whether the effects of the misstatement relate to a single element, account or item in the financial statements that constitutes an exceptionally large proportion of the financial statements, or whether they cannot be confined to specific elements, accounts or items in the financial statements and (where relevant) quantified. In addition, the determination of the pervasiveness of these effects would also take into account whether they are fundamental to users' understanding of the financial statements (in the case of misstated disclosures), or whether they could represent a substantial proportion of the financial statements (in other cases). What is considered a substantial proportion of the financial statements would ultimately depend on the auditor's professional judgment. This guidance is set out in **paragraphs 10 and 11 of the close-off draft (Agenda Item F.2)**. The task force believes that the revised guidance provides clearer and more objective criteria that will better enable auditors to apply the ISA consistently in practice.

Matter for Consideration by the IAASB CAG:

2. Do the Representatives agree that the task force's proposed criteria provide appropriate guidance to the auditor in evaluating the pervasiveness of the effects of a misstatement (or a combination of misstatements)?

3. MULTIPLE UNCERTAINTIES LEADING TO A DISCLAIMER OF OPINION

At the March IAASB meeting, the IAASB considered the significant comments received on exposure and at the December 2005 IAASB CAG meeting regarding the issue of multiple uncertainties leading to a disclaimer of opinion (**Issue B2 of Agenda Item F.1**). The task force presented a revised rationale for a disclaimer of opinion arising from the existence of multiple uncertainties, in response to comments received on exposure. The task force argued that to be consistent with the conceptual framework for disclaimers of opinion, the rationale needed to be laid out in terms of the auditor being unable to obtain sufficient appropriate audit evidence about management's assertions regarding the uncertainties. Some IAASB members observed that this situation was not truly an evidence issue, as the need to disclaim an opinion arose more from the combined multiple effects on the financial statements of the interaction of the various uncertainties, such that the auditor would conclude that it is not possible to form an opinion on the financial statements as a whole (i.e. the original exposure draft position). Other IAASB members argued against this view on the basis that there should be no case for the auditor to disclaim an opinion if the auditor has obtained sufficient appropriate audit evidence about management's assertions regarding each of the uncertainties and their disclosure.

As a result of the vote taken at the March IAASB meeting on this issue, the task force has reflected the majority view (9 vs. 7) of the IAASB in the revised draft, i.e. that it should be the

IAASB CAG PAPER

IAASB CAG Agenda (May 2006)

Agenda Item F

Modifications—Significant Comments on Proposed ISAs 705 & 706

combined multiple effects of the uncertainties that lead to the disclaimer. Given that a situation of multiple uncertainties would likely be rare in practice, the task force decided not to give the issue undue prominence that would detract from the general principles in the proposed ISA. Accordingly, there is no obligation or requirement imposed on the auditor in such a situation. Instead, the proposed ISA provides succinct guidance in **paragraph 14 (Agenda Item F.2)** to highlight the issue so that the auditor may determine whether a disclaimer of opinion would be appropriate in the circumstances.

Matter for Consideration by the IAASB CAG:

3. Do the Representatives agree with the majority view of the IAASB on the rationale for the auditor to disclaim an opinion in the extremely rare case of multiple uncertainties?

4. DISCLOSURE OF OMITTED INFORMATION IN THE AUDITOR'S REPORT

Based on comments received on exposure and at the December 2005 IAASB CAG meeting (**Issue B3 in Agenda Item F.1**), the task force proposed that the ISA should not require the auditor to include omitted disclosures in the auditor's report that management had failed to disclose. Some IAASB members disagreed with this view, arguing that it would not be in the public interest. Other IAASB members agreed with the revised approach proposed by the task force, arguing that doing otherwise would extend the auditor's responsibilities to include management's responsibility for preparing the financial statements, and regulators' responsibility for policing compliance. In response to the latter view, it was noted that the auditor would not really be assuming management's role if the information were readily available.

As a result of the vote taken at the March IAASB meeting on this issue, the task force has reflected the majority view (11 vs. 6) of the IAASB in the revised draft, i.e. that the ISA should require the auditor to disclose omitted information in the auditor's report, unless impracticable or prohibited by law or regulation (effectively reinstating the exposure draft position). The relevant requirement is set out in **paragraph 45 of the close-off draft (Agenda Item F.2)**. In response to comments from the IAASB seeking clarification of the guidance on impracticability, the task force has provided further elaboration of the guidance originally provided in the exposure draft, including guidance addressing the situation where the disclosures would be voluminous in relation to the auditor's report. This enhanced guidance is set out in **paragraph 46 of the close-off draft (Agenda Item F.2)**.

Matter for Consideration by the IAASB CAG:

4. Do the Representatives agree with the IAASB's position on this issue in light of the revised and enhanced guidance on impracticability?

Proposed ISA 706

5. CRITERIA FOR EMPHASIS OF MATTER PARAGRAPHS

IAASB CAG PAPER

IAASB CAG Agenda (May 2006)

Agenda Item F

Modifications—Significant Comments on Proposed ISAs 705 & 706

At the March IAASB meeting, the IAASB considered the significant comments received on exposure and at the December 2005 IAASB CAG meeting regarding the proposed criteria for emphasizing matters in the auditor's report (*Issue C1 in Agenda Item F.1*). The task force highlighted that respondents to the exposure draft had expressed significant concern regarding the proposal that the auditor should emphasize a matter when the criteria specified in the exposure draft are met (i.e. that the matter is both fundamental and unusual). In particular, respondents were concerned that this could lead to an unwarranted proliferation of emphasis of matter paragraphs in auditors' reports. To respond to this concern, the task force proposed to revise the purpose of the requirement such that there would be a limitation on the use of emphasis of matter paragraphs to specified circumstances. This would thus avoid the issue of proliferation that would otherwise undermine the effectiveness of this communication tool.

The IAASB noted, however, that the task force's revised wording appeared to convey an inconsistent message. Further, a view was expressed that the auditor should not be prohibited from communicating matters that the auditor believes should be brought to users' attention. Consequently, it was suggested that a consideration of the need to emphasize a matter might be a more appropriate approach in this ISA.

The task force discussed this suggestion and concluded that a requirement for the auditor to consider an emphasis of matter could be problematical, as it would compel the auditor to consider such matters for each and every audit. Accordingly, the task force decided to revise the relevant wording in the proposed ISA such that the auditor would be allowed the flexibility to exercise professional judgment in determining when to emphasize a matter, provided the matter was already presented and disclosed in the financial statements and it met the specified criteria. However, to make it clear that an emphasis of matter is limited only to situations when those criteria have been met, the task force decided to add a safeguard in terms of a bold-letter requirement that a matter not be emphasized unless all the specified criteria have been met (*paragraphs 7 and 8 of the close-off draft (Agenda Item F.3)*).

In addition, the task force decided that the substance of the paragraphs describing the meaning of the terms "fundamental" and "unusual" in the previous draft could be subsumed into the paragraph setting out the criteria proper (*paragraph 7 Agenda Item F.3*), particularly as the description for "unusual" was relatively brief. Doing so would also avoid the need to separately define or describe the two terms.

Matter for Consideration by the IAASB CAG:

5. Do the Representatives agree that the revised approach for emphasis of matter paragraphs in the auditor's report provides appropriate flexibility to the auditor in highlighting matters the auditor considers necessary to bring to users' attention, yet adequately limits their use to specified circumstances?

IAASB CAG PAPER

IAASB CAG Agenda (May 2006)

Agenda Item F

Modifications—Significant Comments on Proposed ISAs 705 & 706

Material Presented

Agenda Item F.1 Issues Paper (including the task force's response to significant comments on exposure and report back on IAASB CAG comments on the identified issues) – **IAASB CAG PAPER**

Agenda Item F.2 “Close Off” draft of Proposed ISA 705 (May 2006 IAASB Agenda Item 7-B) – **FOR REFERENCE PURPOSES ONLY**

Agenda Item F.3 “Close Off” draft of Proposed ISA 706 (May 2006 IAASB Agenda Item 7-D) – **FOR REFERENCE PURPOSES ONLY**

The remainder of the May 2006 IAASB meeting material for this topic is available from <http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0065>.