

# IAASB CAG REFERENCE PAPER

IAASB CAG Agenda (May 2006)

Agenda Item F.3

Modifications—Proposed ISA 706 “Close off” Draft – May 2006 IAASB Agenda Item 7-D

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

(Effective for auditors’ reports dated on or after [Date])

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International Standard on Auditing (ISA) 706, “Emphasis of Matter Paragraphs and Other Matter(s) 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.

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### Introduction

1. This International Standard on Auditing (ISA) establishes standards and provides guidance on:
  - (a) Circumstances when the auditor includes an emphasis of matter paragraph or an other matter(s) paragraph in the auditor’s report on the financial statements; and
  - (b) 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 auditor’s report when the auditor is able to express an unmodified opinion on a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation.
3. [Proposed] ISA 701, “The Independent Auditor’s Report on Other Historical Financial Information,” establishes standards and provides guidance on the auditor’s report when the auditor is able to express an unmodified opinion on historical financial information other than (a) a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation, and (b) summary audited financial statements.
4. [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 [proposed] ISA 701 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 matter(s) paragraph in an auditor’s report issued in accordance with ISA 700 (Revised), [proposed] ISA 701 or [proposed] ISA 705. The Appendix to this ISA provides an illustrative report based on the form and content of the auditor’s report as set out in ISA 700 (Revised).

### Emphasis of Matter Paragraph in the Auditor’s Report

6. In rare circumstances, the auditor may consider a matter disclosed in the financial statements to be of such importance to users’ understanding of the financial statements as a whole that it would be appropriate to draw their attention to it. For example, it may be appropriate to draw users’ attention to an uncertainty that could affect the entity’s business as a whole, such as a going concern uncertainty. An emphasis of matter paragraph in the auditor’s report provides the means for the auditor to do so.
7. When a matter presented and disclosed in the financial statements meets the following criteria, the auditor may judge it appropriate to emphasize the matter in the auditor’s report:

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- (a) The matter is of such importance that it is fundamental to the users’ understanding of the financial statements;
  - (b) The matter occurs infrequently and is out of the ordinary course of the entity’s business;
  - (c) The auditor has obtained sufficient appropriate audit evidence about the matter; and
  - (d) The matter is not materially misstated in the financial statements.
8. **A widespread use of emphasis of matter paragraphs diminishes the effectiveness of the auditor’s communication of such matters and, accordingly, the auditor should not emphasize a matter presented and disclosed in the financial statements unless all the criteria in paragraph 7 have been met.**
9. ISA 570, “Going Concern,” requires the auditor to include an emphasis of matter paragraph in the auditor’s report on financial statements 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.
10. Examples of circumstances other than a going concern uncertainty that may meet the criteria set out in paragraph 7 include:
  - An uncertainty relating to the future outcome of an exceptional litigation or regulatory action (for example, the pending outcome of a major arbitration case which could significantly affect the entity’s financial position);
  - Significant related party transactions that occur rarely, disclosure of which is fundamental to the users’ understanding of the financial statements;
  - Application of a new accounting standard (for example, a new International Financial Reporting Standard) that has a pervasive effect on the financial statements in advance of its effective date (i.e., where early application is permitted);
  - A major catastrophe that has had, or continues to have, a significant effect on the entity’s financial position.
11. The inclusion of an emphasis of matter paragraph in the auditor’s report does not affect the auditor’s opinion. An emphasis of matter is not a substitute for either (a) the auditor expressing a qualified opinion or an adverse opinion, or disclaiming an opinion, when required by the circumstances of a specific audit engagement (see [proposed] ISA 705), or (b) disclosures in the financial statements that the applicable financial reporting framework requires management to make.
12. **The auditor should include the emphasis of matter paragraph immediately after the opinion paragraph in the auditor’s report and use the heading “Emphasis of**

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**Matter.” The emphasis of matter paragraph should clearly highlight the matter being emphasized and indicate where relevant disclosures that fully describe the matter can be found in the financial statements. The emphasis of matter paragraph should also indicate that the auditor’s opinion is not modified in respect of the particular matter, or, if the auditor’s opinion has been modified in respect of another matter, that the auditor’s opinion is not further modified by the matter being emphasized.**

13. 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 matter has not been appropriately disclosed or that there is a disagreement with management.
14. The example report in the Appendix provides an illustration of an emphasis of matter paragraph in an auditor’s report that contains a qualified opinion.

### **Other Matter(s) Paragraph in the Auditor’s Report**

15. Considerations regarding the inclusion of an emphasis of matter paragraph in the auditor’s report apply only to matters that are already presented and disclosed in the financial statements.
16. The auditor may consider it necessary to use the auditor’s report as a means of communicating information relating to matters other than those that are presented and disclosed in the financial statements. Such information is referred to in this ISA as “Other Matter(s)” in order to distinguish it from a matter highlighted in an emphasis of matter paragraph.
17. **If the auditor considers it necessary to communicate matter(s) other than those that are presented and disclosed in the financial statements and this is not prohibited by law or regulation, the auditor should do so in a separate paragraph in the auditor’s report with the subheading “Other Matter(s),” placed after the auditor’s opinion and any emphasis of matter paragraph.**
18. The content of the other matter(s) paragraph reflects clearly that such other matter(s) are not required to be presented and disclosed in the financial statements.
19. Examples of other matters that are not required to be recognized or disclosed in the financial statements by the applicable financial reporting framework include the following:
  - (a) Avoidance of auditor association with materially inconsistent information in a document containing audited financial statements (see ISA 720, “Other Information in Documents Containing Audited Financial Statements”).
  - (b) Circumstances where 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

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current period, or where the prior period financial statements were not audited (see ISA 710, “Comparatives”).

- (c) Where standards, laws or generally accepted practice in a jurisdiction require or permit the auditor to elaborate on matters that provide further explanation of the auditor’s responsibilities in an audit of financial statements or of the auditor’s report thereon.
  - (d) In rare circumstances, other matters that the auditor considers necessary to communicate to the user, for example, where the auditor judges it necessary to explain why the auditor is unable to resign from the engagement even though the possible effect of an inability to obtain sufficient appropriate audit evidence due to a scope limitation imposed by management is pervasive.
20. An other matter(s) paragraph does not deal with circumstances where the auditor has additional reporting responsibilities that are supplementary to the auditor’s responsibility to express an opinion on the financial statements, or where the auditor has been asked to perform and report on additional specified procedures, or to express an opinion on specific matters (see paragraphs 46-49 of ISA 700 (Revised)).

### Communication with Those Charged with Governance

21. **Prior to forming the opinion, the auditor should communicate with those charged with governance regarding emphasis of matter or other matter(s) paragraphs that the auditor will include in the auditor’s report, and the proposed wordings of these paragraphs.**
22. Such communication enables those charged with governance to be made aware of the nature of any specific matters that the auditor intends to highlight in the auditor’s report, and provides them with an opportunity to obtain further clarification from the auditor where necessary.

### Effective Date

23. This ISA is effective for auditors’ reports dated on or after [Date].

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## Appendix

### Example of an Auditors’ Report that Includes an Emphasis of Matter Paragraph

*Auditor’s report with a modified opinion due to materially misstated financial statements arising from a disagreement with management; the report also contains an emphasis of matter paragraph referring to a major uncertainty related to a pending exceptional litigation matter.*

#### INDEPENDENT AUDITOR’S REPORT

*[Appropriate Addressee]*

#### **Report on the Financial Statements<sup>1</sup>**

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X6, 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

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<sup>1</sup> 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.

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expressing an opinion on the effectiveness of the entity’s internal control.<sup>2</sup> 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 qualified audit opinion.

### *Basis for Qualified Opinion*

The company’s short-term marketable securities are carried in the balance sheet at xxx. We do not agree with management regarding the amounts at which these marketable securities are stated. Management has failed to mark them to market but has instead measured them at cost, which constitutes a departure from International Financial Reporting Standards. Had management marked the marketable securities to market, the company would have recognized an unrealized loss of xxx in the income statement for the year. The carrying amount of the securities in the balance sheet would have been reduced by the same amount at December 31, 20X6, and income tax, net income and shareholders’ equity would have been reduced by xxx, xxx and xxx, respectively.

### *Qualified Opinion*

In our opinion, except for the 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, 20X6, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

### *Emphasis of Matter*

Without further qualifying our opinion, we draw attention to Note X to the financial statements, which describes the major uncertainty<sup>3</sup> related to the outcome of the lawsuit filed against the company by XYZ Company in which XYZ has claimed xxx in damages from the company on allegations that the company has infringed on two of XYZ’s patents in developing and marketing the company’s range of lithium-ion batteries.

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<sup>2</sup> 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.”

<sup>3</sup> In highlighting the uncertainty, the auditor uses the same terminology that is used in the note to the financial statements.

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### **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]*