



G A O

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Comptroller General
of the United States

United States Government Accountability Office
Washington, DC 20548

August 10, 2005

Mr. James M. Sylph
Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, NY 10017

Subject: Proposed International Standard on Auditing (ISA) 705, *Modifications to the Opinion in the Auditor's Report* and proposed ISA 706, *Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report*

Dear Mr. Sylph:

This letter provides the U.S. Government Accountability Office's (GAO) comments on the International Auditing and Assurance Standards Board's (IAASB) proposed ISAs 705 and 706 issued in March 2005.

We support the IAASB's effort to enhance the guidance for issuing modifications to the auditor's opinion and for including emphasis of matter paragraphs and other matters paragraphs in the auditor's report. We also support its efforts to assure consistency of the proposed standards with ISA 700, *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*. However, we have concerns with certain matters in the proposed standards that we discuss below.

Proposed ISA 705 - Modifications to the Opinion

While we agree with the IAASB's intent to provide additional guidance on circumstances that may result in a modification to the auditor's opinion and the type of opinion appropriate in the circumstances, we believe that:

- 1) The guidance does not adequately discuss the need for auditors to consider the fair presentation of the financial statements when they determine the type of opinion to issue. ISA 700.15 discusses "extremely rare circumstances when applying the financial reporting framework results in misleading financial statements" and states that in those circumstances auditors should consider the need to modify the auditors' report. We recommend adding a reference to ISA 700.15 or a discussion similar to ISA 700.15 to the section titled "Circumstances Resulting in a Modification to the Auditor's Opinion" in order to improve the clarity and completeness of the proposed standard and to assure consistency with ISA 700.

2) The organization and clarity of the proposed standard could be improved. The current format of the proposed standard is not logical and it contains repetitions and some inconsistencies. In Enclosure 1 to this letter, we provide recommended clarifications for paragraphs 1 through 34 of the proposed standard, including the following changes:

- Paragraph 7 should be moved from the “Introduction” section of the proposed standard and merged with paragraph 8, with redundancies deleted.
- A new subheading titled “Evaluating Circumstances Resulting in a Modification to the Auditor’s Opinion” should be added before subparagraph 9(a). Paragraphs 23, 24, and 30 should be moved to immediately follow the new subheading and to precede subparagraph 9(a). Paragraph 33 and the last sentence of paragraph 25 should be moved between subparagraph 9(d) and paragraph 10. This new section then would include paragraphs 23, 24, 30, subparagraphs 9(a) – 9(d), paragraph 33, the last sentence of paragraph 25, paragraph 10, and new subparagraph 10(a). These paragraphs should be carefully reviewed and any repetitions should be deleted. Paragraphs 21, 22, 26 – 29, 31, 32, and the first sentence of paragraph 25 are repetitious and should be deleted.
- A new subparagraph 10(a) should be added after paragraph 10 to state that if the auditor disclaims an opinion on the financial statements, the auditor should nonetheless disclose any known instances of material misstatements or other reservations about the fair presentation in conformity with the applicable financial reporting framework.

3) The proposed standard should limit the use of the term “disagreements with management” to narrow, well-defined situations, such as disagreements where the auditor believes that, based on audit evidence obtained, the financial statements are not free from material misstatements due to management’s selection of accounting policies, application of those policies, or the adequacy of disclosures, and management disagrees. We have added clarifying language to paragraph 8(a) in Enclosure 1 to address this issue.

We also believe that IAASB should add a more detailed discussion to the guidance in paragraph 20 for situations when management refuses to remove a scope limitation. Auditors should be advised to consider the implications on their risk assessment and on their understanding of the control environment of management’s refusal to remove a scope limitation. In such circumstances, auditors should consider the nature and magnitude of the scope limitation, management’s reasons for refusing to remove the scope limitation, and the potential impact on the auditors’ opinion. We have added language to paragraph 20 in Enclosure 1 to address this issue.

Proposed ISA 706 – Emphasis of Matter Paragraph and other Matters Paragraphs

We support the IAASB’s endeavor to establish additional standards and guidance on circumstances when auditors should consider including an emphasis of matter

paragraph or an other matters paragraph in the auditors' report. We strongly believe in the need for auditors to communicate in their reports important information to assist users in understanding an entity's current financial condition and related risks. For instance, it may be appropriate for auditors to include information related to an overall analysis of the financial statements, such as matters related to risk, potential contingencies, valuations of assets and liabilities, levels of estimation and judgments used in both the financial reporting and the audit process, and any additional information that the auditor believes should be emphasized or disclosed. In addition, it may be appropriate in some cases for auditors to emphasize or point out matters included in management's discussion and analysis when those matters are important to the users' understanding of the financial statements. This type of communication can be especially important in the public sector, as auditors of U.S. government programs and activities are responsible for disclosing all material or significant facts known to them which, if not disclosed, could mislead knowledgeable users, misrepresent the results, or conceal improper or unlawful practices.¹

GAO has included such a "significant matters" section in our report on the 2004 Financial Report of the U.S. Government to discuss two significant matters of emphasis—the nation's fiscal imbalance and the potential impact of prior year restatements—as well as limitations on the scope of our work and material deficiencies in the government's internal control over financial reporting. We included this information in our report because we believe that these "significant matters" are critical to understanding the true financial position of the U.S. Government.

We recommend changing the name of the "emphasis of matter" paragraph to "emphasis of matter related to financial statements" in order to clarify the differences between the "emphasis" paragraph and the "other matters" paragraph for both auditors and users. Without such clarification, it becomes difficult to determine the placement of any additional matters that the auditor may want to include in the auditors' report.

In addition, we recommend incorporating subparagraph 10(b) into paragraph 6 of the proposed standard and deleting paragraph 10 and subparagraph 10(a), so that all criteria required for an emphasis of matter paragraph will be included in one place, thus improving the clarity and usefulness of the standard. We provide more detail about this change in Enclosure 2 to this letter.

Questions Raised in IAASB Explanatory Memorandum

We offer the following responses to the questions raised on pages 6 – 7 of the Explanatory Memorandum to the proposed standards, along with additional GAO recommendations related to proposed ISAs 705 and 706.

IAASB Question 1: The proposed ISA 706 requires the auditor to include an emphasis of matter paragraph in the auditors' report when a significant uncertainty is both

¹ *Government Auditing Standards, 2003 Revision* (GAO-03-673G), paragraph 1.25.

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.

GAO Response to Question 1: We agree that the guidance in paragraph 33 of proposed ISA 705 should be retained; however, it also should be enhanced to further develop the discussion of criteria for determining the type of opinion to issue and to define what is meant by "extreme cases involving multiple uncertainties." We recommend including guidance such as the following:

- a. If, in the auditor's judgment, management has provided sufficient evidence to support its analysis of the nature of the uncertainty and the related presentation or disclosure in the financial statements, the auditor generally should express an unqualified opinion. Depending on the nature of the uncertainty, the auditor may need to add an explanatory paragraph to emphasize or clarify aspects of particular concern to the auditor.
- b. If the uncertainty involves a scope limitation, such as unavailable or insufficient evidence to support recorded amounts or disclosure relating to an uncertainty, the auditor should consider the appropriateness of expressing a qualified opinion or a disclaimer. A disclaimer of opinion may be most appropriate when the cumulative nature and possible effect of multiple uncertainties preclude obtaining sufficient evidence to support management's analysis, presentation, and disclosure.
- c. If the uncertainty involves a departure from accounting principles, such as inadequate disclosure, inappropriate accounting principles, or unreasonable accounting estimates, the auditor should not express a disclaimer. Instead the auditor should express a qualified or adverse opinion, depending on the materiality and pervasiveness of the departure. [AU 508.36 + 508.62]

IAASB Question 2: The proposed ISA 705 mandates the use of subheadings 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 subheadings is desirable in auditors' reports with modifications to the opinion and auditors' reports with an emphasis of matter paragraph or an other matters paragraph.

GAO Response to Question 2: We support the use of subheadings for modifications to the auditors' report, emphasis paragraphs, and other matters paragraphs and we use subheadings in our financial audit reports. We believe that the use of subheadings would make the reports easier to read and is consistent with the format used in ISA 700, *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*.

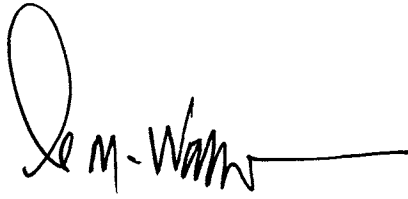
IAASB Question 3: The proposed ISA 706, paragraph 12, uses the term "significant uncertainty" as an example of a matter that the auditor includes in an emphasis of matter paragraph in the auditor's report if, in the auditor's judgment, it is both unusual and of fundamental importance to the user's understanding 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 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?

GAO Response to Question 3: We believe that use of the terms "significant uncertainty" and "material uncertainty" would cause confusion for auditors and for users of audited financial statements unless properly differentiated and defined. Accordingly, we encourage the IAASB to define the term "significant uncertainty" in the broad context and explain how it differs from the term "material uncertainty" as it applies to significant doubts about an entity's ability to continue as a going concern. Otherwise, an auditor or user might erroneously conclude that the evidence and circumstances related to "significant uncertainties," as discussed in proposed ISA 706, is less pervasive and/or persuasive than the evidence and circumstances related to "material uncertainties," as discussed in ISA 570 and IAS 1. The other alternative would be to eliminate the terminology "material uncertainty" from ISA 570 and replace it with language such as "substantial doubt about the entity's ability to continue as a going concern."

We appreciate the opportunity to express our views on these important matters and would be pleased to discuss them with you in further detail.

Sincerely yours,

A handwritten signature in black ink, appearing to read "D M Walker", with a long horizontal line extending to the right.

David M. Walker
Comptroller General
of the United States

Enclosure

cc:

Mr. Kjell Larsson
Auditor General of Sweden and
Chair of the INTOSAI Financial Audit Working Group

Cynthia A. Glassman, Acting Chairman
U.S. Securities and Exchange Commission

The Honorable William J. McDonough, Chairman
U.S. Public Company Accounting Oversight Board

Mr. John Fogarty, Chair
Auditing Standards Board, AICPA



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**Enclosure 1—Specific Suggested Changes to Proposed ISA 705--
MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR’S REPORT**

[GAO’s suggested changes to paragraphs 1 through 34 of proposed ISA 705 are detailed below.]

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.
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.

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 should expresses a modified opinion in the auditor's report on the financial statements when:~~

~~(a) The auditor concludes that, based on the audit evidence obtained, the financial statements are not free from material misstatement due to a disagreement with management about (i) the acceptability of selected accounting policies, (ii) the application of the selected accounting policies, or (iii) the adequacy of disclosures in the financial statements. Accordingly, the financial statements are not prepared in all material respects in accordance with the applicable financial reporting framework or are misleading as a whole.~~

~~(b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that whether 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.

Evaluating Circumstances Resulting in a Modification to the Auditor's Opinion *[new heading]*

[Paragraphs 23 and 24 moved to this section]

XX. [former paragraph 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.

XX. [former paragraph 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 or inability to obtain sufficient appropriate evidence 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 or could affect 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.

[Paragraph 30 moved to this section]

XX. [former paragraph 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.

[Heading moved from before paragraph 21]

Determining the Type of Opinion

The following provides a discussion of the auditors' considerations in determining the appropriate form of modified report.

Disagreements with Management

XX(a) [former subparagraph 9(a)] Qualified opinion: The auditor should expresses a qualified opinion (see paragraph 25) when the auditor concludes that the effect on the financial statements 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. Also, it should be possible to determine and clearly describe in the auditor's report which financial statement line items are or may be affected by the material misstatement.~~

XX(b) [former subparagraph 9(b)] Adverse opinion: The auditor should expresses an adverse opinion (see paragraph 28) when the auditor concludes that the effect of a disagreement with management ~~is~~ has a material and pervasive effect on ~~to~~ the financial statements such that the financial statements are not prepared in accordance with the applicable financial reporting framework or are misleading as a whole. It should be difficult or impossible for the auditor to determine and clearly describe in the auditor's report which financial statement line items are or may be affected by the material misstatement. ~~a qualified opinion is not adequate to disclose the misleading nature of the financial statements.~~

Inability to Obtain Sufficient Appropriate Audit Evidence

XX(c) [former subparagraph 9(c)] Qualified opinion: The auditor should expresses a qualified opinion (see paragraph 25) when the auditor concludes that the possible effect of an inability to obtain sufficient appropriate audit evidence about one or more matters, while material, in the auditor's judgment ~~could not be~~ would not have a pervasive effect on the financial statements and therefore, the financial statements are not misleading. ~~and do not require a disclaimer of opinion. This may be the case when~~ It is should be 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.

XX(d) [former subparagraph 9(d)] Disclaimer of opinion: The auditor should expresses a disclaimer of opinion (see paragraph 31) when the possible effect of an inability to obtain sufficient appropriate audit evidence about one or more assertions has a ~~is~~ material and pervasive effect on ~~to~~ the financial statements such that the auditor is unable to express an opinion on the financial statements. It should be difficult or impossible for the auditor to clearly describe in the auditor's report the effect on the financial statements.

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

[Paragraph 33 moved to this section]

XX. [former paragraph 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.

[The last sentence of paragraph 25 moved to this section]

XX. [former paragraph 25, last sentence] (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.)

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.

[The column heading "materially" in the table should be changed to "materially and not pervasively"]

10(a) If the auditor disclaims on opinion on the financial statements, the auditor should nonetheless disclose any known instances of material misstatements or other reservations about the fair presentation in conformity with the applicable financial reporting framework.

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) and 8(b), 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

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. As discussed in paragraph 8(b), 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 should requests the removal of that limitation. If management does not remove the limitation, the auditor should considers the implications for the auditor's risk assessment and understanding of the control environment, taking into consideration the nature and magnitude of the scope limitation and management's reasons for refusing to remove the scope limitation. The auditor also should consider 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, should ~~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.

[Heading moved to before the subheading "Disagreements with Management"]

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.~~

[Paragraphs 23 and 24 moved to follow paragraph 9]

~~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.~~

[The last sentence of paragraph 25 moved to follow subparagraph 9(d)]

~~(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.~~

[Paragraph 30 moved to precede subparagraph 9(a)]

~~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.~~

[Paragraph 33 moved to follow paragraph 9(d)]

~~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.

[GAO has no suggested changes to paragraphs 35 through 46 or the appendix of proposed ISA 705.]

**Enclosure 2—Specific Suggested Changes to Proposed ISA 706--
EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTERS PARAGRAPHS IN THE
INDEPENDENT AUDITOR'S REPORT**

[GAO's suggested changes to paragraphs 6 and 10 of proposed ISA 706 are detailed below.]

6. The auditor should emphasize in the auditor's report a matter reported or disclosed in the financial statements when, in the auditor's judgment, ~~both~~ all 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, and

[Paragraph 10(b) incorporated into this section]

(c) [former paragraph 10 (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)).

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~~

[Paragraph 10(b) incorporated into paragraph 6]

~~—— (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)).~~