

INTERNATIONAL STANDARD ON AUDITING 701
MODIFICATIONS TO THE INDEPENDENT
AUDITOR'S REPORT¹

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

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International Standard on Auditing (ISA) 701, "Modifications to the Independent Auditor's Report" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.



¹ This ISA establishes standards and provides guidance to be applied when the independent auditor's report should be modified. ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" establishes standards and provides guidance to be applied when the auditor is able to express an unqualified opinion and no modification to the auditor's report is necessary.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the circumstances when the independent auditor's report should be modified and the form and the content of the modifications to the auditor's report in those circumstances.
2. ISA 700, "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 independent 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 unqualified opinion and no modification to the auditor's report is necessary. ISA 800, "The Independent Auditor's Report on Special Purpose Audit Engagements" establishes standards and provides guidance on the form and content of the independent auditor's report in other audit engagements. This ISA describes how the auditor's report wording is modified in the following situations:

Matters that Do Not Affect the Auditor's Opinion

- (a) Emphasis of matter

Matters that Do Affect the Auditor's Opinion

- (a) Qualified opinion,
 - (b) Disclaimer of opinion, or
 - (c) Adverse opinion.
3. Uniformity in the form and content of each type of modified report will further the user's understanding of such reports. Accordingly, this ISA includes suggested wording of modifying phrases for use when issuing modified reports.
 4. The illustrative reports in this ISA are based on the auditor's report on general purpose financial statements for a business enterprise. The principles relating to the circumstances when the auditor's report needs to be modified are, however, also applicable to reports on other engagements related to the audit of historical financial information, such as general purpose financial statements for entities of a different nature (for example, a not-for-profit organization) and the audit engagements described in ISA 800 the illustrative reports would be adapted as appropriate in the circumstances.

Matters that Do Not Affect the Auditor's Opinion

5. In certain circumstances, an auditor's report may be modified by adding an emphasis of matter paragraph to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such an emphasis of matter

paragraph does not affect the auditor's opinion. The paragraph would preferably be included after the paragraph containing the auditor's opinion but before the section on any other reporting responsibilities, if any. The emphasis of matter paragraph would ordinarily refer to the fact that the auditor's opinion is not qualified in this respect.

6. **The auditor should modify the auditor's report by adding a paragraph to highlight a material matter regarding a going concern problem.**
7. **The auditor should consider modifying the auditor's report by adding a paragraph if there is a significant uncertainty (other than a going concern problem), the resolution of which is dependent upon future events and which may affect the financial statements.** An uncertainty is a matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.
8. An illustration of an emphasis of matter paragraph for a significant uncertainty in an auditor's report follows:

Without qualifying our opinion we draw attention to Note X to the financial statements. The Company is the defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.

(An illustration of an emphasis of matter paragraph relating to going concern is set out in ISA 570, "Going Concern.")

9. The addition of a paragraph emphasizing a going concern problem or significant uncertainty is ordinarily adequate to meet the auditor's reporting responsibilities regarding such matters. However, in extreme cases, such as situations involving multiple 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.
10. In addition to the use of an emphasis of matter paragraph for matters that affect the financial statements, the auditor may also modify the auditor's report by using an emphasis of matter paragraph, preferably after the paragraph containing the auditor's opinion but before the section on any other reporting responsibilities, if any, to report on matters other than those affecting the financial statements. For example, if an amendment to other information in a document containing audited financial statements is necessary and the entity refuses to make the amendment, the auditor would consider including in the auditor's report an emphasis of matter paragraph describing the material inconsistency.

Matters that Do Affect the Auditor's Opinion

11. An auditor may not be able to express an unqualified opinion when either of the following circumstances exist and, in the auditor's judgment, the effect of the matter is or may be material to the financial statements:
 - (a) There is a limitation on the scope of the auditor's work; or
 - (b) There is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

The circumstances described in (a) could lead to a qualified opinion or a disclaimer of opinion. The circumstances described in (b) could lead to a qualified opinion or an adverse opinion. These circumstances are discussed more fully in paragraphs 16-21.

12. **A *qualified opinion* should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion. A qualified opinion should be expressed as being 'except for' the effects of the matter to which the qualification relates.**
13. **A *disclaimer of opinion* should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.**
14. **An *adverse opinion* should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.**
15. **Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s) on the financial statements.** Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion on the financial statements and may include a reference to a more extensive discussion, if any, in a note to the financial statements.

Circumstances that may Result in Other than an Unqualified Opinion

Limitation on Scope

16. A limitation on the scope of the auditor's work may sometimes be imposed by the entity (for example, when the terms of the engagement specify that the auditor will not carry out an audit procedure that the auditor believes is

necessary). However, when the limitation in the terms of a proposed engagement is such that the auditor believes the need to express a disclaimer of opinion exists, the auditor would ordinarily not accept such a limited engagement as an audit engagement, unless required by statute. Also, a statutory auditor would not accept such an audit engagement when the limitation infringes on the auditor's statutory duties.

17. A scope limitation 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 physical inventories). It may also arise when, in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable. In these circumstances, the auditor would attempt to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unqualified opinion.
18. **When there is a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.**
19. Illustrations of these matters are set out below.

Limitation on Scope—Qualified Opinion

"We have audited ... (remaining words are the same as illustrated in the introductory paragraph – see paragraph 60 of ISA 700).

Management is responsible for ... (remaining words are the same as illustrated in the management's responsibility paragraph – see paragraph 60 of ISA 700).

Our responsibility is to express an opinion on these financial statements based on our audit. *Except as discussed in the following paragraph*, we conducted our audit in accordance with ... (remaining words are the same as illustrated in the auditor's responsibility paragraphs – see paragraph 60 of ISA 700).

We did not observe the counting of the physical inventories as of December 31, 20X1, since that date was prior to the time we were initially engaged as auditors for the Company. Owing to the nature of the Company's records, we were unable to satisfy ourselves as to inventory quantities by other audit procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to physical inventory quantities, the financial statements give a true and fair view of ... (remaining words are the

same as illustrated in the opinion paragraph – paragraph 60 of ISA 700).”

Limitation on Scope—Disclaimer of Opinion

“We were engaged to audit the accompanying financial statements of ABC Company, which comprise the balance sheet as of 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 is responsible for ... (remaining words are the same as illustrated in the management’s responsibility paragraph – see paragraph 60 of ISA 700).

(Omit the sentence stating the responsibility of the auditor.)

(The paragraph discussing the scope of the audit would either be omitted or amended according to the circumstances.)

(Add a paragraph discussing the scope limitation as follows:

We were not able to observe all physical inventories and confirm accounts receivable due to limitations placed on the scope of our work by the Company.)

Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements.”

Disagreement with Management

20. The auditor may disagree with management about matters such as the acceptability of accounting policies selected, the method of their application, or the adequacy of disclosures in the financial statements. **If such disagreements are material to the financial statements, the auditor should express a qualified or an adverse opinion.**
21. Illustrations of these matters are set out below.

Disagreement on Accounting Policies—Inappropriate Accounting Method—Qualified Opinion

“We have audited ... (remaining words are the same as illustrated in the introductory paragraph – see paragraph 60 of ISA 700).

Management is responsible for ... (remaining words are the same as illustrated in the management’s responsibility paragraph – see paragraph 60 of ISA 700).

Our responsibility is to ... (remaining words are the same as illustrated in the auditor's responsibility paragraphs – see paragraph 60 of ISA 700).

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with International Financial Reporting Standards. The provision for the year ended December 31, 20X1, should be xxx based on the straight-line method of depreciation using annual rates of 5% for the building and 20% for the equipment. Accordingly, the fixed assets should be reduced by accumulated depreciation of xxx and the loss for the year and accumulated deficit should be increased by xxx and xxx, respectively.

In our opinion, *except for the effect on the financial statements of the matter referred to in the preceding paragraph*, the financial statements give a true and fair view of ... (remaining words are the same as illustrated in the opinion paragraph – see paragraph 60 of ISA 700).”

Disagreement on Accounting Policies—Inadequate Disclosure—Qualified Opinion

“We have audited ... (remaining words are the same as illustrated in the introductory paragraph – see paragraph 60 of ISA 700).

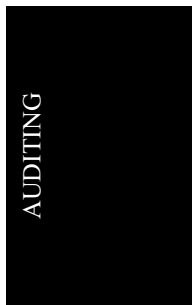
Management is responsible for ... (remaining words are the same as illustrated in the management's responsibility paragraph – see paragraph 60 of ISA 700).

Our responsibility is to ... (remaining words are the same as illustrated in the auditor's responsibility paragraphs – see paragraph 60 of ISA 700).

On January 15, 20X2, the Company issued debentures in the amount of xxx for the purpose of financing plant expansion. The debenture agreement restricts the payment of future cash dividends to earnings after December 31, 19X1. In our opinion, disclosure of this information is required by ...²

In our opinion, *except for the omission of the information included in the preceding paragraph*, the financial statements give a true and fair view of ... (remaining words are the same as illustrated in the opinion paragraph—see paragraph 60 of ISA 700).”

² Refer to relevant statutes or law.



Disagreement on Accounting Policies—Inadequate Disclosure—Adverse Opinion

“We have audited ... (remaining words are the same as illustrated in the introductory paragraph – see paragraph 60 of ISA 700).

Management is responsible for ... (remaining words are the same as illustrated in the management's responsibility paragraph – see paragraph 60 of ISA 700).

Our responsibility is to ... (remaining words are the same as illustrated in the auditor's responsibility paragraphs – see paragraph 60 of ISA 700).

(Paragraph(s) discussing the disagreement.)

In our opinion, because of the effects of the matters discussed in the preceding paragraph(s), the financial statements do not give a true and fair view of (or 'do not present fairly, in all material respects,') the financial position of ABC Company as of December 31, 19X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.”

Effective Date

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