

BASIS FOR CONCLUSIONS CANADIAN AUDITING STANDARD (CAS) 706, Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

September 2009

This Basis for Conclusions has been prepared by staff of the Auditing and Assurance Standards Board (AASB). It relates to, but does not form part of, Canadian Auditing Standard 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.

Background

In July 2007, the International Auditing and Assurance Standards Board (IAASB) issued its Exposure Draft of International Standard on Auditing (ISA) 706 (Revised and Redrafted), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* (ED-ISA 706). The IAASB approved final ISA 706 in June 2008 subject to confirmation by the Public Interest Oversight Board (PIOB) that due process was followed. This confirmation was received in October 2008.

In September 2007, the AASB issued its Exposure Draft to adopt proposed ISA 706 as CAS 706 (ED-CAS 706) to replace Section 5701, OTHER REPORTING MATTERS. There were 8 respondents to ED-CAS 706 (identified below).

The AASB approved CAS 706 in October 2008. The Auditing and Assurance Standards Oversight Council reviewed due process followed by the AASB in the development of this CAS prior to its issuance in the CICA Handbook – Assurance.

Purpose of this Basis for Conclusions

This Basis for Conclusions has been prepared to make Canadian stakeholders aware of the following.

- (a) A Basis for Conclusions prepared by IAASB staff for ISA 706 is available on the IAASB web site, and provides information on how the IAASB dealt with comments received on significant matters in response to the ED-ISA 706.
- (b) Information on how the AASB dealt with significant matters arising from comments received in response to its ED-CAS 706 is also available. This information is set out below.

Significant Matters

AASB's Consideration of Amendments to ISA Wording

1. CAS 706 contains no amendment to the ISA wording. As described below, ED-CAS 706 proposed an amendment regarding an Other Matter paragraph but Re-ED-CAS 210 proposed no amendment. The position in the Re-ED CAS 210 was supported by all respondents.

Circumstances in Which an Other Matter Paragraph May Be Necessary

2. As reflected in ED-CAS 700, *The Independent Auditor's Report on General Purpose Financial Statements*, the AASB proposed an amendment to proposed ISA 210, *Agreeing the Terms of Audit Engagements*, to require the auditor to include an Other Matter paragraph in the auditor's report in certain circumstances. Accordingly, in ED-CAS 706, the AASB proposed to include a new paragraph A7A to refer to this situation. The application material in CAS 706 would have included the following conforming amendment:

In Canada, paragraph 4A of CAS 210, *Agreeing the Terms of Audit Engagements*, requires the auditor to advise management, or those charged with governance, in the terms of the audit engagement that the auditor's report will incorporate an Other Matter paragraph, with a subheading titled "Financial Reporting Framework," when the financial reporting framework to be used in preparation and presentation of general purpose financial statements is not the financial reporting standards established by an organization described in paragraph A7 of CAS 210. Such a paragraph indicates that the financial statements are not, and are not intended to be, prepared and presented in accordance with Canadian generally accepted accounting principles and describes, or draws users' attention to additional disclosures in the notes to the financial statements that describe, each difference between the basis on which the financial statements are prepared and Canadian generally accepted accounting principles. They also describe how the reported financial position and performance of the entity would have differed if it had complied with Canadian generally accepted accounting principles.

3. While respondents to the ED-CAS 210 were supportive of the importance of Canadian GAAP to financial reporting in Canada, and virtually all supported the need to make amendments to proposed ISA 210, the views of respondents with

respect to the nature and effectiveness of the proposed amendment were mixed. The following summarizes the significant points raised by respondents.

- (a) Legislative auditors took the position that the requirements and guidance on determining the acceptability of a financial reporting framework in ED-CAS 210 are open to different interpretations. In particular, they noted that paragraph A9 of ED-CAS 210 could be interpreted as suggesting that a financial reporting framework prescribed by law or regulation by default is an acceptable framework. As a result, they concluded that the proposed amendment in ED-CAS 210 would make it more difficult for auditors to conclude that a legislated framework for general purpose financial statements is not acceptable and possibly lead to the increased use of inappropriate frameworks.
 - (b) Legislative auditors are prevented by their mandates from refusing to accept engagements to audit the financial statements of their respective governments and related bodies. Further, governments have the power to set their own accounting policies. Accordingly, legislative auditors noted that the proposed amendment may place them in the position of having to issue unmodified compliance reports with an Other Matter paragraph on general purpose financial statements prepared using a basis of accounting other than GAAP, when current practice would be to issue a qualified opinion on such financial statements.
 - (c) Some respondents took the position that the amendment did not go far enough because it did not mandate the use of Canadian GAAP in all cases. Other respondents accepted that Canadian GAAP might not be used for general purpose financial statements in all cases but expressed the view that the amendment should be strengthened by requiring quantification of the differences between the basis of accounting used and GAAP, similar to what would be required when the auditor issues a qualified opinion.
 - (d) Some respondents took the position that the amendment was not justified under the AASB's criteria for making amendments to the ISAs because, in their view, Canadian readers of audit reports are no less sophisticated than readers in other jurisdictions. Accordingly, there is no "particular circumstance in Canada" that warrants a different solution. As long as stakeholders carefully read the auditor's report and the notes to the financial statements, they should be able to determine the basis of accounting used in preparing the financial statements and respond accordingly.
 - (e) Some respondents expressed the following concerns.
 - (i) The required disclosures of the differences between the basis of accounting used and GAAP would likely not be identified by management and so auditors would have to take responsibility for identifying these differences and including them in the auditor's report. Therefore, the proposed amendment would likely result in long and cumbersome audit reports.
 - (ii) There is an assumption that the comparison between the basis of accounting used and GAAP will be relevant to the readers of the financial statements, which may not be the case.
 - (iii) The comparison between the basis of accounting and GAAP may be of limited value in future because, under proposals of the Canadian Accounting Standards Board, there will be several different possible frameworks for preparation of general purpose financial statements and users may consider that the framework used for the comparison in the auditor's report is not appropriate for their purposes.
 - (f) Some respondents also stated that some audit engagements may be reconstituted as audits in accordance with the ISAs rather than the CASs in order to avoid the mandatory Other Matter paragraph in the auditor's report.
 - (g) Some respondents also noted that under the CASs an auditor may issue an Other Matter paragraph when the auditor believes that it is necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit. Therefore, an auditor may make the disclosures in the auditor's report even without the proposed amendment.
4. In reviewing the matters raised by respondents, the AASB agreed that the proposed amendment to the auditor's report in ED-CAS 210 contains some significant drawbacks. In addition, the AASB acknowledged that Canadian auditors may have difficulty applying the guidance in ED-CAS 210 when determining the acceptability of a financial reporting framework in the Canadian context. It recognized that the proposed amendment was not intended to address the auditor's determination of the acceptability of the financial reporting framework. It was focused on the form of auditor's report on financial statements prepared using an acceptable financial reporting framework other than an established GAAP. The AASB recognized that if Canadian auditors have difficulty in determining the acceptability of a financial reporting framework, there is a risk that auditors may accept frameworks that are not, in fact, acceptable and this may lead to a decline in the quality of financial reporting in Canada.
5. In considering how best to address the comments made by respondents, the AASB noted that the final ISA 210 includes improvements over proposed ISA 210, on which ED-CAS 210 was based, that responded to concerns raised by the AASB and others concerning unacceptable financial reporting frameworks prescribed by law or regulation. Paragraphs 19-20 of final ISA 210 require that when a financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation, the auditor shall accept the engagement only if:
 - (a) management agrees to provide additional disclosures in the financial statements required to avoid the financial statements being misleading; and

- (b) it is recognized in the terms of the audit engagement that:
- (i) the auditor's report will incorporate an Emphasis of Matter paragraph; and
 - (ii) the auditor's opinion will not include the phrase "present fairly, in all material respects."
6. If these conditions are not present, and the auditor is required by law or regulation to undertake the engagement, the auditor shall evaluate the effect of the misleading nature of the financial statements on the auditor's report, and include appropriate reference to this matter in the terms of the audit engagement. The AASB believes that these requirements assist, for example, a legislative auditor who is required to report on financial statements prepared using an unacceptable financial reporting framework to report appropriately when the financial statements are misleading. Therefore, the AASB believes that paragraphs 19-20 in ISA 210 address the concern expressed by legislative auditors that some general purpose financial statements prepared using a compliance financial reporting framework, could be misleading but that the legislative auditor would nevertheless have to issue an unmodified auditor's report on such statements.
7. The AASB reconsidered whether the form of the auditor's report needed to be amended as proposed in ED-CAS 210. The fundamental question is whether readers of audit reports will be misled by the new form of auditor's report in the CASs. The AASB concluded that it should not make the proposed amendment in ED-CAS 210 for the following reasons.
- (a) Respondents' concerns about the drawbacks of the proposed amendment in ED-CAS 210 are compelling, to the extent, the proposed amendment would not have achieved its objective of improving readers' understanding of the auditor's report.
 - (b) Auditors are permitted under the CASs to add Other Matter paragraphs to their audit reports when they consider it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in their judgment, is relevant to users' understanding of the audit.
 - (c) The AASB proposed to supplement the material in paragraph A8 of ISA 210 so that auditors will be less likely to find acceptable a financial reporting framework that is not one of the frameworks referred to in the proposed new paragraphs.
8. In the Re-ED CAS 210, stakeholders were asked to indicate whether they support the AASB's decision not to make an amendment regarding an Other Matter paragraph in the auditor's report, as proposed in ED-CAS 210. All of the respondents were supportive of the AASB's decision not to make such an amendment. Accordingly, a reference to this situation in the application material of CAS 706 is not required.

Emphasis of Matter and Other Matter Paragraphs

9. One respondent found it difficult to distinguish between an Emphasis of Matter paragraph and an Other Matter paragraph. Another respondent requested additional examples of an Other Matter paragraph to provide clarity on when such paragraphs would be used. The AASB agreed that Emphasis of Matter paragraphs are new in Canada, although they have been in use in other jurisdictions such as the United States for many years. The AASB also noted that auditors have been adding a paragraph to the auditor's report in accordance with Section 5701 for many years. Accordingly, the AASB was not convinced that adding additional explanations or examples to the final CAS was necessary or that such additions would meet the AASB's amendment criteria. The AASB decided that further non-authoritative guidance might be appropriate in conjunction with further communications the AASB plans to make with respect to the new audit reporting model.

Other Matters

None.

List of Respondents to ED-CAS 706

Auditor General Alberta

Auditor General of Canada

BDO Dunwoody LLP

Canadian Public Accountability Board

Deloitte & Touche LLP

Institute of Chartered Accountants of British Columbia

Ordre des comptables agréés du Québec

Provincial Auditor Saskatchewan

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