

Processes, Controls and Audit

[AA34]

Supplementary for Chapter 08

Audit Reporting

This supplementary to the Study Text will be tested
from January 2019 Examination.
The printed chapter in the book will not be applicable
from January 2019 Examination.

Audit Reporting




Chapter Introduction

Auditors report is the means by which the external auditor expresses his opinion on the truth and fairness of financial statements. Many of the contents of the auditor's report are prescribed by statute. The auditor's report may contain an unmodified or a modified opinion.



Learning Outcomes

At the end of each topic you should be able to;

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|  Explain elements of an unmodified audit report |
|  Assess a given scenario to determine the type of modification required in an audit report |
|  Explain the use of Emphasis of matter |

Detailed Area	Level of Knowledge				Level of Action		
	Factual	Conceptual	Procedural		Comprehension	Application	Analysis
08. Reporting (10%)							
8.1 Evaluating effect of material misstatements		✓				✓	
8.2 Unmodified audit report		✓			✓		
8.3 Modified audit report			✓			✓	
8.4 Emphasis of matter and other matter	✓					✓	



1. Audit Reporting

1.1. The objectives of the Auditor

The objectives of the auditor are;

- (a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained and
- (b) To express clearly that opinion through a written report

1.2 The Auditor's Report

An audit report is a written opinion of an auditor regarding an entity's financial statement. The auditor is required to produce an audit report at the end of the audit which sets out his opinion on the truth and fairness of the financial statements. The report is written in a standard format and SLAuS 700 provides guidance on the form and content of the auditor's report. It states that the auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The report contains a number of consistent elements so that users know the audit has been conducted according to recognized standards.

1.3 Forming an Opinion on the Financial Statements

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In order to form that opinion, the auditor must conclude as to whether reasonable assurance has been obtained that the financial statements as a whole are free from material misstatements. The following matters need to be considered in forming the auditor's opinion.

- Whether sufficient appropriate audit evidence has been obtained.
- Whether identified uncorrected misstatements are material individually or in aggregate to the financial statements.
- The financial statements appropriately disclose the significant accounting policies selected and applied.
- Whether the accounting policies selected and applied are consistent with the applicable financial reporting framework.

- Whether the accounting estimates made by management are reasonable.
- Whether the information presented in the financial statements is relevant, comparable and understandable.
- Whether the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events .
- Whether terminology used in the financial statements including title of each financial statements is appropriate.
- Whether the financial statements achieve fair presentation.

1.4 Elements of an Audit report

According to revised SLAuS 700, content of an audit report is as follows;

- 1) Title
- 2) Addressee
- 3) Auditor's Opinion
- 4) Basis for Opinion
- 5) Going Concern
- 6) Key Audit Matters
- 7) Other Information
- 8) Responsibilities for the Financial Statements
- 9) Auditor's Responsibilities for the Audit of the Financial Statements
- 10) Other Reporting Responsibilities
- 11) CA Sri Lanka Membership Number of the Engagement Partner
- 12) Signature of the Auditor
- 13) Auditor's Address
- 14) Date of the Auditor's Report

Detailed explanations of the above content are as follows;

1) Title

The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor.

2) Addressee

The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement. It is normally address to the share holders or those charge with governance of the entity.

3) Auditor's Opinion

The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

The Opinion section of the auditor's report shall also:

- (a) Identify the entity whose financial statements have been audited;
- (b) State that the financial statements have been audited;
- (c) Identify the title of each statement comprising the financial statements;
- (d) Refer to the notes, including the summary of significant accounting policies; and
- (e) Specify the date of, or period covered by, each financial statement comprising the financial statements.

4) Basis for Opinion

The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion",

That,

- a) States that the audit was conducted in accordance with Sri Lanka Auditing Standards.
- (b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SLAuSs.
- (c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with the Code of Ethics for Professional Accountants ; and
- (d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

5) Going Concern

The auditor shall report regarding the inappropriateness of management's use of going concern assumption in accordance with SLAuS 570 (Going Concern)

6) Key Audit Matters

For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate Key Audit Matters (KAM) in the auditor's report in accordance with communicating Key Audit Matters in the Independent Auditor's Report (SLAuS 701)

When the auditor is otherwise required by law or regulator or decides to communicate key audit matters in the auditor's report, the auditor shall do.

7) Other Information

Where applicable, the auditor shall report in accordance with the auditor's responsibilities relating to other information in Document Containing Audited Financial Statements (SLAuS 720)

8) Responsibilities for the Financial Statements

The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." The auditor's report shall use the term that is appropriate

in the context of the legal framework in the particular jurisdiction and need not refer specifically to “management”. In some jurisdictions, the appropriate reference may be to those charged with governance.

9) Auditor’s Responsibilities for the Audit of the Financial Statements

It states that the objectives of the auditor are to obtain reasonable assurance and issue an auditor’s report that includes the auditor’s opinion.

Auditor provides a reasonable assurance, but is not a guarantee that an audit always detect a material misstatement when it exists; and state that misstatements can arise from fraud or error.

10) Other Reporting Responsibilities

Other reporting responsibilities shall be addressed in a separate section in the auditor’s report with a heading titled “Report on Other Legal and Regulatory Requirements”.

11) CA Sri Lanka Membership Number of the Engagement Partner

The CA Sri Lanka membership number of the engagement partner shall be included in the auditor’s report on financial statements of listed entities.

12) Signature of the Auditor

The auditor’s report must be signed. The auditor’s signature is either in the name of the audit firm, the personal name of the auditor or both.

13) Auditor’s Address

The auditor’s report shall name the location in the jurisdiction where the auditor practices.

14) Date of the Auditor’s Report

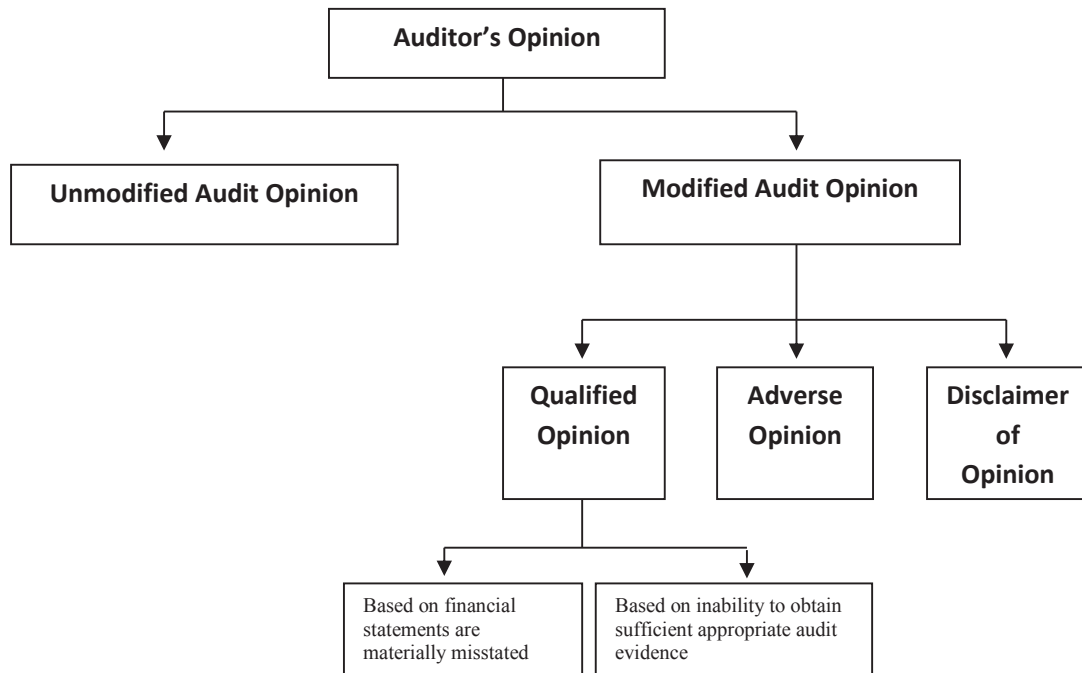
The auditor’s report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor’s opinion on the financial statements.



2. Auditor’s opinion

An auditor after obtaining sufficient audit evidence, issues an audit report that expresses his opinion about the true and fair view of the entity’s operations.

Auditor’s opinion can be divided as follows;



2.1 Unmodified Audit opinion

The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with applicable financial reporting framework.

Specimen of unmodified audit report

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company

Report on the Audit of the Financial Statements

Opinion

We have audited the financial statements of ABC Company which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements give a true and fair view of the financial position of the Company as at December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

Basis for Opinion

We conducted our audit in accordance with Sri Lanka Auditing Standards (SLAuSs). Our responsibilities under those standards are further described in the Auditor's Responsibilities

for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by CA Sri

Lanka (Code of Ethics) and we have fulfilled our other ethical responsibilities in accordance with the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

(Description of each Key Audit Matter.)

Going Concern

The financial statement of the Company has been prepared using the going concern basis of accounting. Management has not identified a material uncertainty that may cast significant doubt on the entity's ability to continue as a going concern, and accordingly none is disclosed in financial statements of the Company. Based on our audit, we also have not identified such a material uncertainty. However, neither management nor the auditor can guarantee the Company's ability to continue as a going concern.

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

Reporting in accordance with the reporting requirements in SLAuS 720

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation of financial statements that give a true and fair view in accordance with Sri Lanka Accounting Standards and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

- Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SLAuSs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.
- As part of an audit in accordance with SLAuSs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:
 - Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
 - Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
 - Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
 - Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
 - Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with ethical requirements in accordance with the Code of Ethics regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matter communicated with those charged with governance, we determine those

matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulations precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequence of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on Other Legal and Regulatory Requirements

As required by section 163(2) of the Companies Act No. 07 of 2007, we have obtained all the information and explanations that were required for the audit and, as far as appears from our examination, proper accounting records have been kept by the Company.

CA Sri Lanka membership number of the engagement partner responsible for signing this independent auditor's report is [number].

[Signature in the name of the audit firm, the personal name of the auditor, or both]

[Audit Firm Address]

[Date]

2.2. Modified Audit Opinion

The auditor shall modify the opinion in the auditor's report when:

- (a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Types of modified opinions

SLAuS 705 establishes three types of modified opinions, namely,

- a. A qualified opinion
- b. An adverse opinion
- c. A disclaimer of opinion

The decision regarding which type of modified opinion is appropriate depends upon:

- (a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated, and

- (b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

Circumstances when a modification to the auditor's opinion is required

- **Nature of material misstatement**

A material misstatement of the financial statements may arise in relation to

- (a) The appropriateness of the selected accounting policies
- (b) The application of the selected accounting policies or
- (c) The appropriateness or adequacy of disclosures in the financial statements

- **Nature of an inability to obtain sufficient appropriate audit evidence**

The auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from

- (a) Circumstance beyond the control of the entity
- (b) Circumstances relating to the nature or timing of the auditor's work
- (c) Limitation imposed by management

In SLAuS 705 term Pervasive have been defined as following:

A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment:

The auditor has to consider both characteristics of the misstatements in order to correctly understand the implications of misstatements on the financial statements and auditor's report. That is why auditor always evaluates whether uncorrected/undetected misstatements are:

- material and pervasive in which case auditor will give adverse or disclaimer of opinion according to the circumstances; or
- just material but not pervasive in which case the auditor will express a qualified opinion.

Basis for opinion

When the auditor modifies the opinion on the financial statements the auditor shall include a heading immediately after the opinion paragraph to describe the matter which gives rise to the modification;

- Basis for qualified opinion
- Basis for adverse opinion
- Basis for disclaimer of opinion

As appropriate, for the opinion section.

If there is a material misstatement in the financial statements, that relates to specific amounts in the financial statements, the auditor shall include in the Basis for Opinion paragraph a description and a qualification of the financial effects of the misstatements.

If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the Basis for Opinion section the reasons for that inability.

If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall describe the nature of the omitted information.

2.2.1 Qualified opinion

The auditor shall express a qualified opinion when,

- (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Example for Qualified Opinion

Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying financial statements give a true and fair view of, (present fairly, in all material respects) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

Basis for Qualified Opinion

The Company's inventories are carried in the statement of financial position at xxx. Management has not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from Sri Lanka Accounting Standards. The Company's records indicate that, had management stated the inventories at the lower of cost and net realizable value, an amount of xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

We conducted our audit in accordance with Sri Lanka Auditing Standards (SLAuSs).

Our responsibilities under those standards are further described in the Auditor's

Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by CA Sri Lanka (Code of Ethics), and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

2.2.2 Adverse Opinion

The auditor expresses an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Example for Adverse Opinion

Adverse Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying consolidated financial statements do not present fairly do not give a true and fair view of, (do not present fairly) the consolidated financial position of the Group as at December 31, 20X1, and (of) its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

Basis for Adverse Opinion

As explained in Note X, the Group has not consolidated subsidiary XYZ Company that the Group acquired during 20X1 because it has not yet been able to determine then fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis.

Under the Sri Lanka Accounting Standards, the Company should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

We conducted our audit in accordance with Sri Lanka Auditing Standards (SLAuSs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are

independent of the Group in accordance with the Code of Ethics issued by CA Sri Lanka (Code of Ethics) and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

2.2.3 Disclaimer of Opinion

The auditor disclaims an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

Example for Disclaimer of Opinion

Disclaimer of Opinion

We were engaged to audit the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying consolidated financial statements of the Group. Because of the significance of the matter described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements.

Basis for Disclaimer of Opinion

The Group's investment in its joint venture XYZ Company is carried at xxx on the Group's consolidated statement of financial position, which represents over 90% of the Group's net assets as at December 31, 20X1. We were not allowed access to the management and the auditors of XYZ Company, including XYZ Company's auditors' audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the Group's proportional share of XYZ

Company's assets that it controls jointly, its proportional share of XYZ Company's liabilities for which it is jointly responsible, its proportional share of XYZ's income and expenses for the year, and the elements making up the consolidated statement of changes in equity and the consolidated cash flow statement.

Summary of Modified Opinions

The table below illustrates how the auditor's judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

Nature of Matter Giving rise to the Modification	Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
	Material but Not Pervasive	Material and Pervasive
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion



3. Emphasis of matter paragraphs and other matter paragraphs (SLAuS 706)

This Standard deals with additional communication in the auditor's report when the auditor shall;

- (a) Draw users' attention to a matter appropriately presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements; or
- (b) Draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

3.1 Emphasis of Matter Paragraphs in the Auditor's Report

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor needs to follow following guidelines,

- (a) Include the paragraph within a separate section of the auditor's report with an appropriate heading as "Emphasis of Matter"
- (b) Include a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements.
- (c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

3.1.1 Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph

- a. An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- b. A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
- c. Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- d. A major catastrophe that has had, or continuous to have, a significant effect on the entity's financial position.

Examples of emphasis of matter paragraph in the auditor's report

Emphasis of matter

We draw attention to Note x of the financial statements which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

3.2 Other Matter Paragraphs in the Auditor's Report

Other matter paragraph is an additional paragraph which auditor might add if in his eyes it is important to draw attention of user to a matter other than those disclosed or presented in the financial statements.

Circumstances in which Other matter paragraph may be necessary

- Relevant to users' Understanding of the Audit
- Relevant to users' Understanding of the Auditor's Responsibilities or the Auditor's Report
- Reporting on more than one set of financial statements
- Restriction on distribution or use of the auditor's report