

EFFECTIVE REPORTING FOR COMPANY AUDITS – SA 700 (REVISED), SA 705, SA 706 (REVISED) AND QUALIFICATION

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WESTERN INDIA REGIONAL COUNCIL
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May 11, 2013

Introduction...

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- **Standards on Auditing (SAs) deals with Audits and Reviews of Historical Financial Information**
- **Series 700 -799 deals with Audit Conclusions and Reporting**
- **Earlier, Reports given as per SA 700 'Auditor's Report on Financial Statements [Auditing and Assurance Standard (AAS) 28]**

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...Introduction...

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- It covered
 - Basic principles governing the formation of auditor's opinion
 - Basic elements of Auditor's Report
 - Auditor's Report –
 - Unqualified Opinion
 - Modified Reports
 - Emphasis of Matter
 - ✓ Matters not Affect Opinion
 - ✓ Matters Affect Opinion
 - Qualified
 - Adverse
 - Disclaimer

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...Introduction

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- Crisis in 2008 - the then ISA 700 was split into three separate standards
- Revision in SA 700
 - Forming an Opinion and Reporting on Financial Statements
- Introduction of -
 - **SA 705** - Modifications to the opinion in the Independent Auditor's report
 - **SA 706** - Emphasis of Matter paragraphs and Other Matter paragraphs in the Independent Auditor's Report

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SA 700 (REVISED)

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Forming an Opinion and Reporting on Financial Statements

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Scope...

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- Deals with:
 - How to form an opinion? – Auditor's Responsibility
 - How to give a ***clean*** opinion in the Auditor's Report on the general purpose financial statements? – Form and content
- Promotes consistency in the auditor's report– credibility as audit as per globally recognised standards - promote the user's understanding – identify unusual circumstances
- Applicable for audits beginning on or after April 1, 2012

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...Scope...

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- Applies to –
 - audits and not to reviews, compilations or agreed-upon procedures
 - audits of 'general purpose financial statements (FS)' – FS prepared in accordance with a general purpose framework
- General purpose framework -
 - A financial reporting framework designed to **meet the common financial information needs of a wide range of users**. The financial reporting framework may be a fair presentation framework or a compliance framework

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...Scope

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- *Fair Representation Framework*: Where the auditor gives a true and fair report
- It is a financial reporting framework that **requires compliance with the requirements of the framework** and
- that :
 - (a) To achieve the **fair presentation of the financial statements**, it may be necessary for management to **provide disclosures beyond** those specifically required by the framework; or
 - (b) It may be explicitly necessary for management to **depart from a requirement of the framework** to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in **extremely rare circumstances**

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...Scope

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- ***Compliance Framework*** : Where the auditor reports on whether FS comply with the requirements of the applicable laws, or rules and regulations, or a set of contractual terms and conditions
- Requires meeting the requirements of the framework but no freedom to the management

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- **Financial Reporting Standards** in SA 700 means –
 - the **Accounting Standards** issued by ICAI or Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, or the **Accounting Standards for Local Bodies** issued by the ICAI, as may be applicable

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Forming an opinion on FS...

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- Opinion on whether the FS are prepared, in all material respects, in accordance with the **applicable financial reporting framework**
- The auditor is required to conclude that the financial statements as a whole are **free from material misstatement** whether due to fraud or error
- To reach this conclusion, he has to determine whether:
 - Sufficient appropriate audit evidence has been obtained

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...Forming an opinion on FS...

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- Uncorrected misstatements are, individually or in the aggregate, are material
- The required evaluations have been carried out
- Requirements of the reporting framework (e.g. Accounting Standards) have been materially complied with
- Management's judgements in preparing the financial statements are free from 'bias'
- The financial statements adequately disclose the accounting policies selected and applied
- Those accounting policies are appropriate, and consistent with the financial reporting framework

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...Forming an opinion on FS...

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- The accounting estimates made by management are reasonable
- The information presented in the financial statements is relevant, reliable, comparable and understandable
- There are adequate disclosures for users to understand the effect of material transactions and events on the information conveyed in FS
- The terminology used in FS is appropriate

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...Forming an opinion on FS

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- the auditor shall evaluate whether FS achieve fair presentation- to that end also evaluate :
 - The overall presentation, structure and content of the FS
 - Whether the FS, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation
- Whether FS adequately refer to or describe the applicable financial reporting framework

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Form of Opinion

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- **Unmodified Opinion**
 - The auditor shall express **unmodified opinion** when the auditor concludes that the FS are prepared, in all material respects, in accordance with the **applicable financial reporting framework**

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Form of Opinion

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- **Circumstances when not to give Unmodified Opinion, that is, to give Modified Opinion (SA 705) –**
- When the auditor concludes that, based on audit evidence obtained, though sufficient, **the FS as a whole are ‘not free’ from material misstatement(s)**; or
- Due to non-availability of **sufficient appropriate audit evidence** not able to conclude that the FS as a whole are free from material misstatement(s)

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Form of Opinion

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- When reporting under a fair presentation framework, if the auditor **concludes** that **FS do not achieve fair presentation**, auditor should **discuss the matter with management** to resolve the issue (by giving additional disclosures or, in rare cases, departing from the framework) and, based on the outcome, **decide whether he should give a modified opinion**

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Report - Form and content

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- Paragraphs and order :
 - Title } }
 - Addressee } GENERAL
 - Introductory paragraph } SECTION
 - Management's responsibility paragraph } RESPONSIBILITY,
 - Auditor's responsibility paragraph } PARAS
 - Auditor's opinion paragraph } }
 - Other responsibilities paragraph } OTHER MATTERS
 - Signature
 - Date of the auditor's report
 - Place of signature

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- **The title is**

- *INDEPENDENT AUDITOR'S REPORT*

- **Addressee**

- It is usually addressed to those for whom it is prepared

“To the Members of ABC Company Limited”

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Introductory Paragraph

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- Identify the **entity**
- State – FS have been **audited**
- Identify **the title** of each statement of **FS**
- Specifies date or period covered
- Now requires mention of “*summary of significant accounting policies and other explanatory information*” along with the identification of the various FS

“Report on the Financial Statements

*We have audited **the accompanying financial statements** of ABC Company Limited (“the Company”), **which comprise** the Balance Sheet as at March 31, 20XX, and the Statement of Profit and Loss and Cash Flow Statement for the year **then ended**, and **a summary of significant accounting policies and other explanatory information.**”*

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Management Responsibility Paragraph

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- Independent auditors do not share the responsibility for the preparation of FS
- **Management is responsible for the same**
- Previously this was given in a very concise form at the end of the introductory paragraph.

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Management Responsibility Paragraph

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“Management’s Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements that give a true and fair view of the financial position, financial performance and cash flows of the Company in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 (“the Act”). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.”

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Auditor's Responsibility Paragraph

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- Responsibility of the auditor is to **express an opinion on the FS based on the audit**
- A key assertion that is made in this paragraph is that the audit was conducted in accordance with **the SA's**

“Auditor's Responsibility :

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.”

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Auditor's Responsibility Paragraph

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An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, ~~but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control~~. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.”

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Auditor's Opinion Paragraph

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“Opinion

In our opinion and to the best of our information and according to the explanations given to us, the financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:

- (a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;*
- (b) in the case of the Statement of Profit and Loss, of the profit/ loss for the year ended on that date; and*
- (c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.”*

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Other Responsibilities Paragraph

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- This was previously placed before the Opinion Paragraph
- It gave the impression that auditors opinion is based on it which is not the same.

“Report on Other Legal and Regulatory Requirements

1. As required by the Companies (Auditor's Report) Order, 2003 (“the Order”) issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Act, we give in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the Order.

2. As required by section 227(3) of the Act, we report that:

- (a) We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit;*

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Other Responsibilities Paragraph

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(b) In our opinion proper books of account as required by law have been kept by the Company so far as appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from branches not visited by us;

(c) The Balance Sheet, Statement of Profit and Loss, and Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from branches not visited by us];

(d) In our opinion, the Balance Sheet, Statement of Profit and Loss, and Cash Flow Statement comply with the Accounting Standards referred to in subsection (3C) of section 211 of the Companies Act, 1956;

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Other Responsibilities Paragraph

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(e) On the basis of written representations received from the directors as on March 31, 20XX, and taken on record by the Board of Directors, none of the directors is disqualified as on March 31, 20XX, from being appointed as a director in terms of clause (g) of sub-section (1) of Section 274 of the Companies Act, 1956.

~~*(f) Since the Central Government has not issued any notification as to the rate at which the cess is to be paid under section 441A of the Companies Act, 1956 nor has it issued any Rules under the said section, prescribing the manner in which such cess is to be paid, no cess is due and payable by the Company."*~~

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Signature

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- Where the firm is appointed as auditor, the report is signed in the personal name of the auditor and in the name of the firm

“For XYZ and Co.

Chartered Accountants

Firm’s Registration Number

Signature

(Name of the Member Signing the Audit Report)

(Designation)

Membership Number





Place of Signature

Date”

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Changes in some phrases

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- Auditor’s Report  Independent Auditor’s Report
- Profit and Loss account  Statement of Profit and Loss
- Notes to Accounts  Summary of Significant Accounting Policies and Other Explanatory information
- Attached Balance Sheet  Accompanying Financial Statements

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ISSUES

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- How should an auditor frame his opinion where a statute or court order allows an entity to prepare financial statements without meeting a GAAP requirement ? Say, permitted to account certain type of income or expenditure on cash basis
 - The auditor should ***not modify*** his opinion.
 - He should state it in the “*Emphasis of Matter*” paragraph about the modified framework

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ISSUES

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- How should the auditor’s opinion be expressed if the financial statements are prepared in accordance with two financial reporting frameworks ?
 - The auditor may issue two separate opinions, in either two different sentences or in a single sentence.
 - Example : “*the financial statements give a true and fair view in accordance with the accounting principles generally accepted in India and with International Financial Reporting Standards*”
 - If they are in compliance with one framework but not the other, an unmodified opinion may be given on the former and a modified opinion on the latter.

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Differences - SA 700 and ISA 700

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	SA 700	ISA 700
1.	Place of Signature	Location in the jurisdiction where the auditor practices
2.	Firm's Registration Number	No such requirement
3.	In case of qualification - description of all substantive reasons with quantification of possible effects on FS	No requirement for quantification

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SA 705

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Modifications to the Opinion in the Independent Auditor's Report

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Scope

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- Deals with Audit Reports where a **Modification** to the auditor's opinion is necessary
- There can be three types of "modifications" to an auditor's opinion:
 - a "qualified opinion"
 - a "disclaimer of opinion"
 - an "adverse opinion"
- This SA is effective for audits beginning on or after April 1, 2012

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Modification

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- A modified opinion is necessary when :
 - The auditor concludes, based on the audit evidence obtained, that the **Financial statements as a whole are not free from material misstatement; or**
 - The auditor is **unable to obtain sufficient appropriate audit evidence** to conclude that the Financial Statements as a whole are free from material misstatement.

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Types of Modified Opinion

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- ***Qualified Opinion:***
 - When the auditor concludes that misstatements, individually or in the aggregate, **are material, but not pervasive**

- ***Adverse opinion:***
 - The auditor shall express 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

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Types of Modified Opinion

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- ***Disclaimer of an Opinion:***
 - When the auditor is unable to obtain sufficient appropriate audit evidence and concludes that the possible effects on the Financial statements of undetected misstatements, if any, could be **both material and pervasive**

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Summary of Modified Opinions

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Nature of the Matter (giving rise to the Modification)	Auditor's Judgment	
	Material but Not Pervasive	Material and Pervasive
<ul style="list-style-type: none"> Financial Statements are materially misstated 	Qualified opinion	Adverse opinion
<ul style="list-style-type: none"> Inability to obtain sufficient appropriate audit evidence 	Qualified opinion	Disclaimer of opinion

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'Basis of Modified Opinion' Paragraph

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- The Auditor's Report shall include a paragraph of the heading:
 - "Basis for Qualified Opinion"
 - "Basis for Adverse Opinion", or
 - "Basis for Disclaimer of Opinion"
- This paragraph is placed above the Opinion Paragraph
- The auditor shall include in this paragraph, a **description and quantification of the financial effects of the misstatement**, unless impracticable.

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Qualified Opinion

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Basis for Qualified Opinion

As stated in Note XX, Schedule XX the Company has paid Rs XX lakhs as remuneration to managing and other directors, which is in excess of the limits prescribed under the Companies Act, 1956. Had the Company accounted for the remuneration in accordance with law, the loss after tax for the year would have been lower and loans and advances would have been higher by Rs XX lakhs.

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Disclaimer of Opinion

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Basis for Disclaimer of Opinion

- (a) We have not been able to obtain sufficient appropriate audit evidence with regard to the recoverability of Sundry Debtors, particularly having regard to:*
- (i) the aggregate amount of debtors outstanding for a period exceeding six months being Rs. XXX*
 - (ii) debtors in respect of sales during the period aggregating ₹ XXX being fully unrecovered, and (iii) the debtors outstanding at the commencement of the financial year aggregating ₹ XXX being yet to be recovered to the extent of Rs. XXX.*
- (b) There was also a limitation of scope on the audit carried out by us since while observing the physical verification of stock-in trade carried out by the Management during the period, individual items aggregating ₹ XXX per the books of account were not produced to us for physical verification. Accordingly, we were precluded from fully performing our audit procedures in this regard.*

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Adverse Opinion

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Basis for Adverse Opinion

As explained in Note X, the Company has not consolidated the financial statements of subsidiary XYZ Company it acquired during 20XX because it has not yet been able to ascertain the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This acquisition is therefore accounted for as an investment.

Under the accounting principles generally accepted in India, the subsidiary should have been consolidated because it is controlled by the Company. Had XYZ been consolidated, many elements in the accompanying financial statements would have been materially affected. The effects on the financial statements of the failure to consolidate have not been determined.

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'Modified Opinion' Paragraph

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- Where opinion is modified, the paragraph is titled as:
 - "Qualified Opinion"
 - "Adverse Opinion" or
 - "Disclaimer of Opinion"
- In case of Qualified Opinion, due to material misstatement the auditor shall state:

"except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework"

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'Modified Opinion' Paragraph

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- When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the phrase ***“except for the possible effects of the matter(s)…”***
- When the auditor expresses an adverse opinion, he shall state:

“because of the significance of the matter described in the Basis for Adverse Opinion paragraph the financial statements have not been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting is in accordance with a compliance framework”

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'Auditor's Responsibility' Paragraph

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- In a **qualified or adverse opinion**, the auditor shall state that:
 - *“the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's modified audit opinion”*
- In case of a **disclaimer of opinion**, the auditor shall state that:
 - *“Because of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion”.*

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ISSUES

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- *If the management imposes a scope limitation after the auditor has accepted the engagement, what should he do?*
- Auditor shall request that **management remove the limitation**
- If management refuses to do so, the auditor shall **communicate the matter to TCWG** and determine whether it is possible to perform **alternative procedures** to obtain sufficient appropriate audit evidence

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ISSUES

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- If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine that:
 - If the undetected misstatements, could be material but **not pervasive**, the auditor shall **qualify the opinion**;
 - If the possible effects of undetected misstatements, could be **both material and pervasive**, the auditor shall:
 - **Resign** from the audit, where practicable and not prohibited by law **or**
 - If resignation from the audit is not practicable or possible, **disclaim an opinion** on the Financial Statements

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ISSUES

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- *There is a misstatement or a series of misstatements in the financial statements that the auditor evaluates as material and pervasive.*
- *The auditor explains each misstatement in separate paragraphs in his report and then states in his opinion that 'subject to the matters stated in the said paragraphs, the financial statements give a true and fair view'... Is this permissible?*
 - No.
 - The auditor would have to give an adverse or a disclaimer of an opinion

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Issues

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- *What is an auditor obligated to do if he expects to modify his report?*
 - The auditor has an obligation to communicate this to those charged with governance that he intends to do so
 - As well as provide them the proposed wording.

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SA 705 and ISA 705

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- ISA 705 requires the auditor to include in the basis for modification paragraph, a description and quantification of the financial effect of the misstatement.
- SA 705 has been changed also to include the effect of the aggregate quantifications of the misstatements on the financial statements.

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SA 706

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Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

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Scope

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- Deals with
 - Form and content of
 - Emphasis of matter paragraphs and
 - Other matter paragraphs
- in the independent auditor's report
- This SA is effective for audits beginning on or after April 1, 2012

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Emphasis of Matter paragraph

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- An emphasis of matter paragraph deals with matters that are already appropriately presented or disclosed in the financial statements.
- A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

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Emphasis of Matter paragraph

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- Insertion of an emphasis of matter paragraph in the auditor's report **does not make the opinion "modified"**
- An Emphasis of Matter paragraph is **not a substitute** for either the auditor expressing a qualified opinion or an adverse opinion, or disclaiming an opinion
- An emphasis of matter is **not a part of the audit opinion** at all. It is a separate, independent paragraph designed to provide **"additional communication"** to the users.

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Emphasis of Matter paragraph

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- Requirements of emphasis matter paragraph
 - Emphasis of matter paragraph is given **immediately after the opinion paragraph**;
 - It has a heading "Emphasis of Matter"
 - The paragraph must provide a reference to the matter being emphasized and where, in the financial statements, that matter in its elaborated form is to be found; and
 - The paragraph contains a declaration that the auditor's opinion is not modified in respect of the matter emphasized.

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Circumstances

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Examples when an emphasis of matter paragraph is to be included:

- An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.
- Early application (where permitted) of a new accounting standard that has a pervasive effect on the financial statements in advance of its effective date.
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

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“Emphasis of Matter

We draw attention to Note XX of Schedule XX to the financial statements stating that the Company has paid ₹ xx Crores under protest against claims of ₹ xx Crores for expenses which the Company has disputed in matters that are in various stages of litigation. Pending resolution of these disputes by the relevant courts, these expenses have been accounted for in the financial statements based on the management's expectation of the amounts due. Our opinion is not qualified in respect of this matter.”

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Other Matter Paragraph

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- An Other Matter paragraph may be required to enhance users' understanding of an audit.
 - For example,
 - 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

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Other Matter Paragraph

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- Other Matter Paragraph does not include:
 - auditor's report is intended solely for the intended users
 - any information that the auditor is prohibited from providing by law, regulation or other Standards
 - information that is required to be provided by management

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Other Matter Paragraph

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If the other matter pertains to the audit, the auditor's responsibility or the auditor's report insofar as	Where placed in auditors report?
expressing an opinion on the financial statements	placed immediately below the Emphasis of Matter paragraph.
other reporting responsibilities of the auditor (eg., reporting under CARO)	Included in the section titled: "Report on Other Legal and Regulatory Requirements".

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- If an auditor expects to include
 - an emphasis or
 - other matter paragraph in the auditor's report,
- he has an obligation to communicate this to those charged with governance that he intends to do so.

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Differences

Emphasis of Matter	Other Matter
It contains matters that are appropriately presented or disclosed in the financial statements	It contains matters <i>other than those presented or disclosed in the financial statements</i> but the auditor feels the need to bring them to the users' attention
In its definition it uses ".....is fundamental to users' understanding of the financial statements."	In its definition it uses ".....is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report."
Here, the auditor specifically points the readers' attention to these matters.	Here, the information is not given in the financial statement so the users are likely to be unaware of them.
It include matters related to the financial Statements	It includes only information related to the audit, the auditor's responsibility or the auditor's report

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Difference between SA 706 and ISA 706

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- There is no difference between the two.

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ISSUES

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- **Whether Basis for Qualified Opinion paragraph to be stated in bold or italics?**
 - SA 705 doesn't require to highlight the modification. However, if the applicable statute requires the auditor to highlight the same, it should be so presented.
 - Thus, for audits under Companies Act, the qualification will have to be presented in bold or italics.

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- **“Basis for Qualified Opinion” paragraph to be included :**
 - *The Company's inventories are carried in the Balance Sheet at Rs. XXX. Management has not stated the inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from the Accounting Standards referred to in sub-section (3C) of section 211 of the Act. The Company's records indicate that had management stated the inventories at the lower of cost and net realisable value, an amount of ₹ XXX would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by Rs. XXX, and income tax, net profit and shareholders' funds would have been reduced by ₹ XXX, ₹ XXX and ₹ XXX, respectively.*

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- “Qualified Opinion” paragraph to be included :

- *In our opinion and to the best of our information and according to the explanations given to us, **except for the effects of the matter described in the Basis for Qualified Opinion paragraph**, the financial statements give the information required by the Act in the manner so required and **give a true and fair view** in conformity with the accounting principles generally accepted in India:*

(a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;

(b) in the case of the Statement of Profit and Loss, of the profit/loss for the year ended on that date; and

(c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

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THANK YOU

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