Exam technique for Advanced Audit and Assurance

Part 5 – Auditor reporting

Auditor reporting forms an important part of the Advanced Audit and Assurance syllabus and exam. Prior to September 2018 auditor reporting typically featured in one of the optional questions and was often the least popular question each session. Candidates should be aware that as the exam moves to its new syllabus format all questions will be compulsory and one of the 25-mark questions each session will be drawn from the completion and reporting area of the syllabus. Questions could focus on syllabus areas including final evaluation of audit evidence, matters such as going concern and subsequent events, and the reports which auditors produce at the final stage of the audit, including the auditor’s report to shareholders and reports to those charged with governance. This article focusses on auditor reporting to shareholders. It is imperative for candidates to be prepared to answer questions on auditor reporting and will need an understanding of the format of the report, the types of opinions which may be given by the auditor and the other modifications which could be required to an auditor’s report.

Exam questions on the auditor’s report have often taken one of two forms. The first is an appraisal of information provided within a scenario and a requirement to consider further actions and possible reporting implications, the other a critique of draft wording for an auditor’s report. These requirements are slightly different as one is at an earlier stage than the other and hence it is important to focus the answer to what the requirement is asking for. There are also different wordings of the requirements which mean that the answers to two questions may look similar but conclusions have been reached for different reasons.

Audit opinions

The audit opinion is perhaps the most important thing to understand for an auditor’s report question. Where the auditor has gathered sufficient and appropriate evidence that the financial statements are free from material misstatements an unmodified opinion can be issued.

Unmodified opinions

ISA 700 (revised) Forming an Opinion and Reporting on Financial Statements gives two alternative forms for an unmodified opinion. These are:

- In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the company as at 31 December 20X1 and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRS®), or
• In our opinion, the accompanying financial statements give a true and fair view, in all material respects, the financial position of the company as at 31 December 20X1 and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRS®).

Common error in the exam – candidates often state that the first of these opinions is incorrect and that the report should state the financial statements are true and fair – this is not the case, either wording is allowed by the standard.

Modified opinions

The next thing a candidate needs to have clear in their mind are the possible modifications for opinions. These arise if the auditor

• is not able to obtain sufficient appropriate audit evidence
• determines uncorrected material misstatements exist, or
• has concluded that the financial statements are NOT prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework which includes consideration of the qualitative aspects of the entity’s accounting practices, including indicators of possible bias in management’s judgments.

Where this is the case the auditor will need to assess whether the issues considered are material or material and pervasive.

ISA 705 (revised), Modifications to The Opinion in The Independent Auditor’s Report identifies three types of modified opinion:

• Qualified opinion – where the auditors concludes either that the misstatements in the financial statements are material but not pervasive (qualified on the basis of material misstatement) or the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion but conclude the possible effects on the financial statements of undetected misstatements would be material but not pervasive (qualified on the basis of an inability to obtain sufficient audit evidence). Qualified opinions are given in the form of ‘except for’ opinions and examples of the wording for such opinions can be found in ISA 705 (revised) para 17
• adverse opinion – where the auditor concludes that the material misstatements in the financial statements are pervasive (therefore they do not present fairly/are not true and fair) and,
• a disclaimer of opinion where the auditor concludes that there is insufficient evidence on which to base an opinion and the possible effects of undetected misstatements are material and pervasive

In order to distinguish between these types of modified opinion a candidate must determine two things

• Is there a material misstatement or is there insufficient evidence to know whether there is a material misstatement, and
• Is the effect material or material and pervasive?

In determining whether a misstatement is pervasive ISA 705 (revised) gives the following definition:

Pervasive – 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:

(i) Are not confined to specific elements, accounts or items of the financial statements

(ii) If so confined, represent or could represent a substantial proportion of the financial statements, or

(iii) In relation to disclosures, are fundamental to users’ understanding of the financial statements.

Common errors in the exam – candidates often identify correctly there is a material misstatement in the accounts that is not pervasive, then state that the opinion should be unmodified or that the misstatement should be covered by an emphasis of matter paragraph. This is incorrect; a material misstatement which is not pervasive will result in a qualified opinion.

Basis for opinion paragraph
The auditor’s report contains a paragraph **after** the opinion paragraph describing the basis on which auditors form their opinion. Where a modified audit opinion is given the details of the misstatements or the inability to obtain sufficient appropriate audit evidence will be provided.

**Common error in the exam – using outdated standards and stating the basis for opinion paragraph is presented before the audit opinion.**

**Other modifications to the auditor’s report**

In a requirement that asks candidates to consider the effect on the auditor’s report rather than the effect on only the audit opinion, there are other modifications which should be considered.

**Emphasis of matter (EoM)** – used by auditors where they consider that there is a matter correctly presented or disclosed in the financial statements that the auditor deems to be of fundamental importance to a user’s understanding of the financial statements. This paragraph is used to draw attention to the matter being emphasised by referring to where it is presented and disclosed in the financial statements. This paragraph is not used for going concern uncertainties.

**Common errors in exams**

- Using an EoM paragraph for a material misstatement or failure to obtain evidence – these give rise to qualified opinions
- Using an EoM paragraph for uncertainties surrounding going concern – these have a separate paragraph
- Using an EoM paragraph for something which would be a key audit matter for a listed company.

**Other matter (OM)** – used by auditors where they consider it necessary to communicate a matter other than those presented or disclosed in the financial statements that is relevant for a user’s understanding of the audit, auditor’s responsibilities or the auditor’s report.

**Other information**

ISA 720 (Revised), *The Auditor’s Responsibilities Relating to Other Information* also requires the inclusion of an Other Information paragraph which includes:

- A statement that management is responsible for the other information
- An identification of:
  - other information, if any, obtained by the auditor prior to the date of the auditor’s report, and
  - for an audit of financial statements of a listed entity, other information, if any, expected to be obtained after the date of the auditor’s report
- A statement that the auditor’s opinion does not cover the other information and Accordingly that the auditor does not express (or will not express) an audit opinion or any form of assurance conclusion thereon
- A description of the auditor’s responsibilities relating to reading, considering and reporting on other information as required by this ISA, and
- When other information has been obtained prior to the date of the auditor’s report, either:
  - a statement that the auditor has nothing to report, or
  - if the auditor has concluded that there is an uncorrected material misstatement of the other information, a statement that describes the uncorrected material misstatement of the other information

**Common exam error – not appreciating that the audit has a responsibility for reporting misstatements in the other information in addition to inconsistencies.**
Material Uncertainty Related to Going Concern – ISA 570 (revised)

Going Concern requires auditors to include a paragraph drawing attention to uncertainties relating to going concern which are adequately disclosed in the financial statements by reference to those disclosures.

Common exam errors

- Including going concern issues in an EoM paragraph – this is no longer in line with revised ISAs 570 and 706
- Stating that an uncertainty arising due to going concerns means the break up basis of accounting should be used – an uncertainty such as withdrawal of one form of finance or the loss of a major customer may give rise to uncertainties but do not always mean a company will cease trading and be required to use the break up basis of accounting. Candidates should appreciate that it is extremely rare to see ‘break-up basis’ financial statements, which are only used where a reporting entity has no option but to wind up operations.
- Using the uncertainty paragraph where the uncertainty is not disclosed in the financial statements – this would give rise to a material misstatement and require a qualified or adverse opinion.

Note that all three of these modifications do not result in a qualified opinion. They modify only the report. None of these is an alternative to a qualification of the audit opinion.

Key audit matters

For listed companies, auditors are required to include a Key Audit Matters (KAM) section within the auditor’s report ISA 701 Communicating Key Audit Matters in the Independent Auditor’s Report defines key audit matters as —those matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with Those Charged with Governance. They are areas of high risk, high levels of management judgement or significant events or transactions arising within the period. The auditor is required to explain why each matter was deemed important and how it was addressed during the audit.

This section cannot be used to avoid giving a qualified opinion.

Exam focus

Auditor reporting is covered by many ISAs and it is often hard to visualise how an auditor’s report should look. Many candidates in the exam still refer to outdated auditing standards or do not seem to understand how the auditor’s report flows. Listed companies generally publish their annual report online and these can be accessed freely. Candidates should take time to read the auditor’s reports for several real companies to appreciate this fundamental part of the syllabus. The profession revolves around the auditor’s report, the audit process and the ethics and professional issues that surround it all lead to this crucial document that is the output of the audit. View an example of a real auditor’s report

Exam questions on reporting can take different forms. Here’s some examples from past questions and common misstates that have been seen in candidate answers. The links below can be used to see the scenario details relating to the question:

March/June 2018, Q5

Scenario summary

Candidates were presented with an extract from a proposed auditor’s report for a listed company, comprising KAM, qualified opinion and EoM paragraphs.

Requirement

Critically appraise the extract from the auditor’s report on the consolidated financial statements of the Blackmore Group for the year ended 31 March 2018.

Exam focus

To critically appraise candidates should consider each piece of information and assess whether it is correct or incorrect, describing why and how to amend it as necessary.
Commons mistakes in the exam

- stating the qualification matter should have been an EoM
- stating the financial statements should be prepared on a break up basis because of a potential breach of funding covenants (it's an uncertainty over going concern but the company is not about to commence winding up)
- stating that the auditor should not disclose the potential uncertainty regarding going concern because it hasn’t happened yet (the uncertainty exists therefore it will impact the auditor’s report)
- not identifying that the uncertainty discussion did not refer to adequate disclosures in the accounts (these are needed if the opinion will not be qualified)
- not identifying that the EoM paragraph should have been a Material Uncertainty Relating to Going Concern paragraph
- saying the report was missing a title and signature – this was an extract not a complete report

September/December 2017, Q5b(ii)

Scenario summary

Candidates were presented with material misstatements identified during the audit. Part b(i) asked candidates to explain matters which should be discussed with management in relation to the uncorrected misstatements and then lead to b(ii) below

Requirement

Assuming that management does not adjust the misstatements identified, evaluate the effect of each on the audit opinion.

Commons mistakes in the exam

- considering the effects on wider areas of the auditor’s report not specifically the opinion
- assuming that misstatements in disclosures didn’t need a qualification and recommending using an EoM instead – a material misstatement in disclosure still requires a qualified audit opinion
- believing that the auditor’s disagreement with management regarding the reduction in provision was an inability to obtain sufficient appropriate evidence rather than a material misstatement
- suggesting putting qualification matters that were material but not pervasive in an EoM paragraph rather than qualifying the opinion.

September/December 2016

Scenario summary

Candidates were presented with two unresolved issues arising from the audit of a non-listed company. The first was an imposed limitation in scope arising from a confidentiality agreement signed by the client and the second was a significant event properly disclosed in the financial statements.

Requirement

In respect of each of the matters described above, discuss the implications for the auditor’s report and recommend any further actions necessary.

Note this requirement covers the auditor’s report not simply the opinion and is for a non-listed company.

Commons mistakes in the exam

- ignoring the requirement for further actions in addition to the auditor’s report implications – this includes trying to resolve the limitation of scope with management and the requirement to communicate the matter to TCWG
- recommending an EoM paragraph for the limitation of scope – this has to give rise to a qualified opinion
- omitting the description of the effect on the basis for opinion paragraph or stating it should be placed before the audit opinion
- not stating that an EoM paragraph needs to draw attention to the significant event disclosure in the notes to the financial statements or that this matter does not modify the
Key points for exam technique

In summary, candidates should expect to answer a question on auditor reporting in exams under the new syllabus. To perform well in this area candidates must:

- Have an understanding of the types of audit opinion available
- Understand the different additional components of the auditor’s report
- Read the requirements carefully to identify the correct areas to cover and whether:
  - the company is listed,
  - the question asks for more than effects on the auditor’s report such as actions to be taken
  - the response is relating to the audit opinion only or the wider effects on the auditor’s report

Conclusion

With good preparation and a logical approach this area of the exam can enable candidates to score strong marks and question practice will help to hone those skills.

Written by a member of the Advanced Audit and Assurance examining team

Related Links

- Student Accountant hub

Advertisement