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ACCA Paper P7

Advanced Audit and Assurance

For exams in 2010

Chapter 2

Audit Reports



START The Big Picture

The one thing all statutory audits of limited liability companies have in common is that at the end of the day an **independent auditor** has to issue a **report** to the **shareholders** as the owners of the company.

The auditors must **report** their **opinion** in respect of **two main issues**:

1. Whether the financial statements give a '**true and fair view**' (or present fairly in all material respects) the company's financial position and performance, and
2. Whether the financial statements have been '**properly prepared**' in accordance with any relevant professional recommendations and/or statutory provisions.

This is **not** of course a **new topic**, as you should **previously** have **studied** this area in **F8**. At the **P7** stage, it is **almost certain** that any **questions** that you get in this area will be **practical** in nature, with few marks, if any, going for pure knowledge.

Given that the **examiner** has stated that she is **concerned** in the auditing paper with testing candidates' **accounting knowledge**, you must **anticipate** that **scenarios** will include **accounting treatments** whose **acceptability** or **otherwise** you will have to be prepared to **discuss**.

In the old syllabus audit reports were one of the declared favourite topics of the examiner and there was a question every time. The **current examiner** has stated that she

acknowledges the **importance** of this syllabus area, **but** students should **not assume** that there will necessarily **always** be a **question** in this area. Having said that, experience to date shows that there is a better than even chance that you will be faced with such a question in your sitting and this must be seen as a **high priority area**.



KEY TERMINOLOGY

ISA 700 The Auditors Report on Financial Statements identifies the key elements of the auditor's report:

1. Title
2. Addressee
3. Introductory paragraph
4. Statement of responsibilities of management
5. Statement of responsibilities of the auditors
6. Scope paragraph
7. Opinion
8. Auditor's signature
9. Date of report
10. Auditor's address

Modified Audit Reports

The standard audit report may be **modified**, such modification may or may not result in the auditors giving a qualified opinion. It is important to remember that **modification** of the audit report will **only** be **required** if there is some **material** issue.

With a practical type of question always make sure that you **use** any **information** available in the **scenario** to help you **assess materiality** in a sensible way, vague references to the fact that you would 'consider materiality' will **NOT** impress the examiner.

For example, let us say you are given the information that a company's profit before tax (PBT) is \$1,000,000 and that the company has failed to make provision for a known bad debt of \$150,000. **State the obvious** by saying that at 15% of PBT the bad debt is material, in that a standard benchmark would be to consider an item impacting on PBT as being material if it is in the range of 5% to 10% of such PBT.

It is also important when assessing materiality to remember that this must be considered so far as the user and not the preparer of financial statements is concerned. A useful **working definition of materiality** may be taken as

'transactions and other events are likely to be seen as material in the context of a company's financial statements if their omission, misstatement or non-disclosure would matter to a proper understanding of such financial statements on the part of a potential user.'

Modified audit report with unqualified opinion

Sometimes there may be **matters** relating to the financial statements which, whilst **fully and adequately disclosed** within the financial statements, the **auditor** considers worthy of **bringing** to the particular **attention** of **users**.

The auditor achieves this by including in the audit report an additional paragraph known as an '**emphasis of matter**' paragraph. This paragraph will be 'self-contained' and will **NOT** otherwise **impact** on the **standard wording** of an unmodified report.

Key points to remember in relation to the use of such paragraph are:

- it should have **a separate heading**
- it should be positioned **AFTER** the opinion paragraph
- it must be made clear that the **audit opinion is not qualified** and so this paragraph should start with words such as '**Without qualifying our opinion we draw attention to**'

Past examiners' reports have indicated that **many candidates** have been **unclear** as to how and when to make proper **use of an emphasis of matter paragraph**. It is **important**, therefore, that you are totally happy with this aspect of audit reports.

Examples of where the use of such paragraph would be appropriate include:

- where there the financial statements have been prepared on a going concern basis, but this is dependent upon some **significant uncertainty which is fully and adequately disclosed** in the notes to the financial statements
- where there is a **material inconsistency** between the **financial statements** and the **Directors' Report** and the adjustment required to remove the inconsistency would need to be made in the Directors' Report but the directors are not prepared to make such adjustment.

Modified audit report with qualified opinion

According to ISA 700, there are two main circumstances which might give rise to the auditors deciding that is necessary for them to qualify their audit opinion:

1. **Limitation on scope** which arises where the auditor has been unable to carry out some audit work which normally they would have expected to perform and/or where the circumstances are such that audit evidence which the auditor would normally expect to be available for some reason does not exist.
2. **Disagreement** exists between the auditors and client management in relation to some aspect of the financial statements.

The type of qualified opinion to be given will depend not just on the circumstances as indicated above, but also on how serious the limitation on scope or disagreement is namely is it:

1. **Material but not pervasive**, that is to say that the limitation on scope or disagreement is confined to one particular aspect of the financial statements, such that the auditor is able to say that 'except for' this matter the financial statements give 'a true and fair view etc'.
2. **Material and pervasive**, that is to say that the nature of the limitation on scope or disagreement is such that it will **impact on the overall view given by the financial statements**. In such situation if it is caused by **limitation on scope**, the auditor should give a **Disclaimer of Opinion**, whereas if it is because of **disagreement**, they should give an **Adverse Opinion**.

The circumstances giving rise to a qualified audit opinion should be described in a separate paragraph which appears **BEFORE** the opinion paragraph. Wherever possible, the auditor should **quantify the qualification circumstances** as this should make it easier for the reader to appreciate its significance.



KEY KNOWLEDGE

Summary Diagram of Approach to Practical Audit Report Questions

