



## **Completion and Reporting**

***by Laura Morgan, on behalf of the CPA Ireland Examinations Team for Strategic Level Advanced Audit and Assurance, March 2022.***

Completion and Reporting is an important aspect of the syllabus, and normally accounts for 15% of the marks in each exam. Modifications to the audit report is examined regularly and appears to be an area the students struggle with.

According to ISA 200, the objective of an audit is to **express an opinion** on a set of financial statements.

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

### **It is important the students are familiar with the below key standards in this area:**

- ISA 700 – Forming an Opinion and Reporting on Financial Statements
- ISA 705 – Modifications to the Opinion in the Independent Auditor’s Report
- ISA 706 – Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report

### **ISA 700 – Forming an Opinion and Reporting on Financial Statements**

ISA 700 requires the auditor to form an opinion on whether the financial statements are prepared in all materials respects, in accordance with the applicable financial reporting framework.

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatements, whether due to fraud or error.

### **ISA 705 – Modifications to the Opinion in the Independent Auditor’s Report**

Modifications to the audit opinion can occur in two situations:

1. There is a **disagreement** – The financial statements as a whole **are not free from material misstatement**; or
2. There has been a **limitation of scope** - The auditor is **unable to obtain sufficient appropriate audit evidence** to conclude whether the financial statements as a whole are free from material misstatement.

#### **Material misstatement:**

If you identify a misstatement, it is important to decide on whether it is material to the financial statements. *Please refer to the materiality benchmarks to help you with this (see ISA 320).*

It is important to note that this category includes non-disclosures or inadequate disclosures in the financial statements.

**Examples:**

- Non-disclosure of going concern problems in the financial statements.
- Disagreement over inventory valuation (e.g. inventory is not valued at the lower of cost and NRV in accordance with IAS 2).
- Inadequate provision for bad debts.
- Disagreement over warranty provisions/legal provisions.

**Inability to obtain sufficient appropriate evidence** can also be referred to as 'Limitation of Scope'.

**Examples:**

- The entity does not allow the auditor to perform necessary audit procedures.
- The auditor is unable to perform audit procedures due to circumstances.
- The entity's records are inadequate and there are no other means available to be able to obtain sufficient appropriate evidence.

Once the auditor has determined there is a misstatement, or a potential misstatement due to a disagreement or limitation of scope, and they conclude that the misstatement is material, a modified opinion will be issued. The auditor then needs to determine how material the misstatement is or could be. A material misstatement can either be:

1. **Material but not pervasive** – while the item is material, it is not so material that the entire set of financial statements does not give a true and fair view; or
2. **Material and pervasive** – the item is so material and pervasive that the entire set of financial statements does not give a true and fair view.

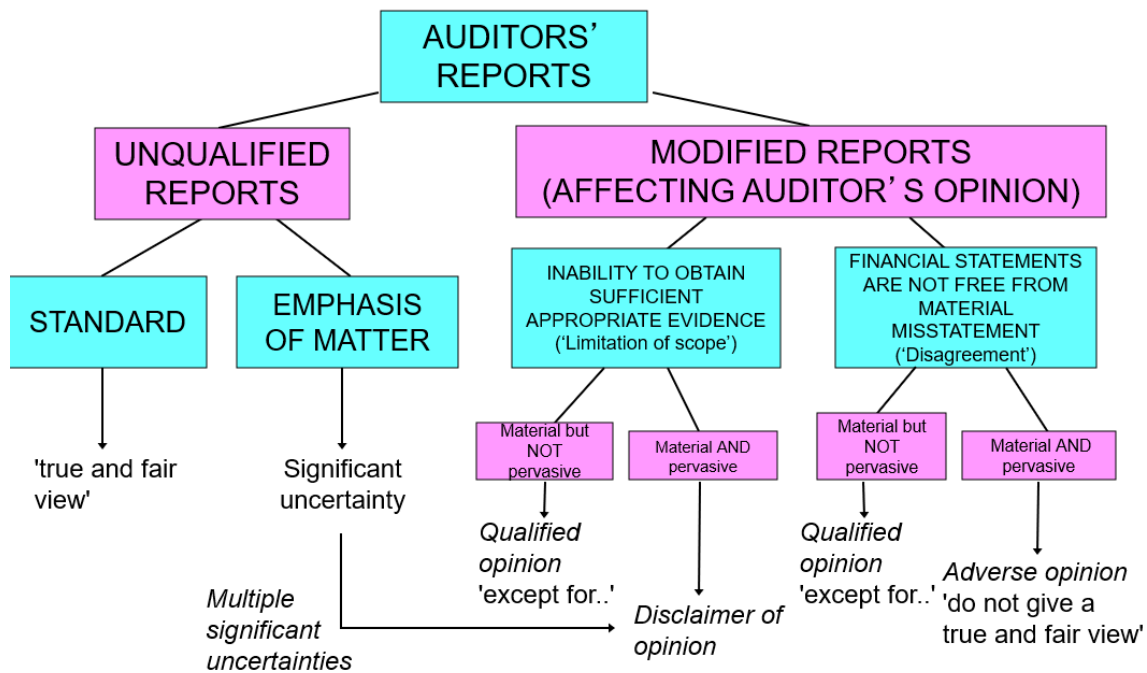
**It is important to understand the definition of pervasive:**

- Effects on the financial statements are pervasive if in the auditor's judgement are not confined to specific elements accounts or items of the financial statements; or
- If confined to specific elements, accounts or items that could represent a substantial proportion of the financial statements (e.g. is 50% or more of a particular account balance); or
- In the case of disclosures, are fundamental to the users' understanding of the financial statements.

**Summary**

- The opinion will only be modified if the matter is considered material to the financial statements.
- If the matter is immaterial – no modification to the opinion is required.
- If the matter is material but not pervasive – qualified opinion ("except for").
- If the matter is material and pervasive – adverse opinion or disclaimer of opinion.
- Deciding whether the matter is material but NOT pervasive OR material AND pervasive is entirely the auditor's judgement.

The below flowchart can be very helpful:



**ISA 705 – Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report**

- This standard gives guidance on using the emphasis of matter and ‘other matter’ paragraphs.
- It is used to refer to a matter appropriately presented or disclosed in the financial statements that the auditor considers necessary to bring to the attention of the reader.
- Example: uncertainty relating to the future outcome of litigation/going concern.

**EXAM TIPS – 5 step approach**

**STEP 1:** What is the issue? It is also important to refer to relevant ISAs/accounting standards where appropriate.

**STEP 2:** Limitation of scope/Disagreement/Emphasis of Matter

**STEP 3:** Is it material? Explain

**STEP 4:** Is it pervasive? Explain

**STEP 5:** Conclude on the appropriate audit report (use the flowchart above to help you)

**Past paper example: Advanced Audit and Assurance, April 2021, Question 2:**

**Requirement:**

Critically appraise the potential impact on the audit report for each of the below situations described.

**Aqua Ltd (Aqua)**

Aqua has been a client of your firm for several years. The draft financial statements show that Aqua's profit before tax is €3.1 million. Prior to the year end, Aqua received legal correspondence which stated it is being sued for a breach of contract with an important customer. The customer is threatening to claim damages of €6.5 million. The audit team has reviewed correspondence and obtained legal confirmations from Aqua's solicitors. Aqua's solicitors stated that, due to the subjectivity of the matter, they are unable to conclude whether it is likely that Aqua will win or lose the case. Therefore, Aqua has not made any provision in the financial statements; however Aqua has made the relevant note disclosures. The engagement partner agrees with the accounting treatment and is satisfied that the note includes all the necessary information for the users of the financial statements to understand the situation.

1. According to IAS 37, a provision should be recognised when the following 3 criteria is met: 1. It is a past event, 2. It is probably the claim will be successful, 3. The claim can be reliably measured. In this case, the client is right to not make a provision in the financial statements, as only one of the above three criteria is met.
2. There is a significant uncertainty, however there is no limitation of scope.
3. The claim is material as it is 209% of profit before tax.
4. The claim is fundamental to the users understanding of the financial statements, as a successful claim would turn Aqua's profit into a loss and could therefore be seen as pervasive.
5. The audit report should be modified using an Emphasis of Matter paragraph and a brief description should draw the users' attention to the relevant disclosure note. The opinion is not modified in respect of this matter.

**Bongo Ltd (Bongo)**

Your firm is the external auditor of Bongo for the year ended 28 February 2021. Bongo is a clothing retailer and maintains a perpetual inventory system which it uses to calculate the value of inventory at the year end. In March 2021, a computer virus corrupted the data held on the inventory system resulting in the loss of records relating to the value of inventory at 28 February 2021. The finance director was responsible for taking back-ups. However, he was very busy preparing the financial statements at the year end, and he forgot to take a back-up. The last available one was dated 23 December 2020. The directors have estimated the value of inventory at year end to be €1.95 million; however, they are not able to provide suitable documentation to support this. The profit before tax per the draft financial statements is €15.4 million.

1. According to IAS 2, inventory should be valued at the lower of cost and net realisable value. The issue in this situation is that they do not have any suitable documentation to support the year-end inventory balance.
2. The opinion should be modified due to the inability to obtain sufficient appropriate audit evidence – Limitation of Scope.
3. The value of inventory is material as it is 12.66% of profit before tax.
4. The issue is not pervasive as it is isolated to the inventory balance.
5. The auditor should issue a qualified opinion ('except for').

### **Windsor Ltd (Windsor)**

You have almost completed the external audit of Windsor for the year ended 31 January 2021. However, on completion of your subsequent events review, you noticed a letter dated 1 March 2021 from the administrator of Yellow Ltd (Yellow), a customer of Windsor. From the letter you can see that Yellow is in administration and will not be able to pay the balance of €785,000 due to Windsor at 31 January 2021. The directors in Windsor are adamant they are not making a provision for the balance, as they are relying on a loan from the bank, and a bad debt provision will significantly decrease their profit. Windsor's draft financial statements for the year ended 31 January 2021 show a profit before tax of €3.9 million and total assets of €28.3 million. The directors also said, *"sure the letter was not received until after the year end anyway, so there is no need for a provision"*.

1. The receipt of a letter from the administrator of Yellow provides evidence of conditions existing at the year end and is therefore an adjusting subsequent event under IAS 10. The amount due from Yellow should be written off.
2. If the client does not post a journal to write off the balance, then there will be a disagreement.
3. The amount is 20.13% of profit before tax and 2.77% of total assets and is therefore material.
4. The matter is not pervasive as it only affects specific items in the financial statements, and it does not represent a substantial proportion of either balance.
5. A modified auditor's report/opinion should be issued due to the material misstatement and therefore a qualified ('except for') opinion should be issued.