CHAPTER SIXTEEN

AUDITOR'S REPORT

16.0 Introduction

The audit report is the end product of an audit process in which the auditor communicates his findings regarding the credibility of the financial statements which are presented by the management of company to the shareholders and other interested parties. Audit work is aimed towards the objective of reporting to the members of an organization who are the owners of the company. The auditors reporting framework is provided for in the company's act and the professional standards. According to the company's act the auditor to include the following in the audit report; His opinion on whether:

- The client company has maintained proper books of accounts
- He received all the information and explanations that he deemed necessary for the audit
- He received returns from the branches
- Whether the books of accounts are in agreement with the financial statements
- Whether the financial statements give a true and fair view and have been prepared in accordance with the identified financial reporting framework.

According to international standards on Auditing (ISA 700), the auditor's report should contain a clear expression of the auditor's opinion on the financial statements based on the work done.

16.1 Elements of An Audit Report.

1. Title.
2. Addressee.
3. Auditors opinion.
4. Basis for opinion.
5. Key audit matters
6. Responsibilities for financial statements.
7. Other reporting responsibilities
8. Name of the engagement partner
9. Signature of the Auditor
10. Auditor's Address
11. Date of the report.

1. **Title.**
   The audit report should have an appropriate title indicating that it is the independent auditors report. This title signifies that all the ethical requirements were satisfied in the audit.
2. **Addressee.**
   The auditor's report should be appropriately addressed as read by the circumstances of the engagement and local regulations. The report is usually addressed to the shareholders of the company

3. **Opinion section**

The first part of the auditor's report should include the auditor's opinion, and should have the heading "Opinion." The Opinion section of the auditor's report should also include the following:

- ➔ Identification the entity whose financial statements have been audited;
- ➔ Statement that the financial statements have been audited;
- ➔ Identification of the title of each statement comprising the financial statements;
- ➔ Reference to the notes, including the summary of significant accounting policies; and
- ➔ Specification of the date of, or period covered by, each financial statement comprising the financial statements.

4. **Basis of opinion section**

The auditor's report shall include a section, directly below the Opinion section, with the heading "Basis for Opinion". This section should include the following;

- ➔ A statement that the audit was conducted in accordance with International Standards on Auditing.
- ➔ Reference to the section of the auditor's report that describes the auditor's responsibilities under the ISAs;
- ➔ A statement that the auditor is independent of the entity and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements and identification of jurisdiction of origin of the relevant ethical requirements
- ➔ A statement on 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**

This section should be included where applicable meaning the entity under audit has going concern issues.

6. **Key audit matters**

These are 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.

7. **Auditors address (auditors physical address)**

The report should name a specific location which is ordinarily the city where the auditor maintains an office that has a responsibility of the audit. This therefore is the physical address.

8. **Auditor's signature.**

The auditor's signature is read for authenticity purpose. The report should be signed in the name of the audit firm, personal name of the auditor or both. The auditor's report is ordinarily signed in the name of the firm because the firm assumes the responsibility of the audit.

16.2 Contents of the statement of the management's responsibility

i) To prepare the financial statements in accordance with the applicable financial reporting framework,

ii) To implement internal control that are necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

iii) To assess the ability of the entity to continue as a going concern and the appropriateness of the use of the going concern basis of accounting
iv) To disclose any matters relating to going concern.
v) Identification of those responsible for the oversight of the financial reporting process.

16.3 Contents of the statement of the auditor's responsibility

i) The objectives of the auditor
ii) A statement that although a reasonable assurance is a high level of assurance, there is no guarantee that an audit conducted in accordance with ISAs will detect all material mis-statement.
iii) A statement that misstatements could arise from fraud or error and an explanation of the concept of materiality.
iv) Auditors exercise of professional skepticism throughout the audit
v) Description of the auditor's responsibilities as comprising of the following:
   - ➔ To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error;
   - ➔ To design and perform audit procedures responsive to those risks;
   - ➔ To obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion.
   - ➔ To 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 entity's internal control.
   - ➔ To evaluate the appropriateness of accounting policies used.
   - ➔ To evaluate the reasonableness of accounting estimates included in the financial statements.
   - ➔ To assess the adequacy related disclosures made by management.
   - ➔ To conclude on the appropriateness of management's use of the going concern basis of accounting.

vi) auditor communication 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 the auditor identifies during the audit;

16.4 Considerations in expressing an opinion

The auditor should consider the following matters in expressing an opinion on the financial statements:

i) Adequacy of disclosure of the significant accounting policies selected and applied;
ii) Appropriateness of the selected accounting policies;
iii) Reasonableness of the accounting estimates made by management;
iv) Relevance, reliability, comparability, and understandability of the information presented in the financial statements

v) Adequacy of disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements;
vi) Appropriateness of the terminology used in the financial statements, including the title of each financial statement;
vii) The overall presentation, structure and content of the financial statements.
viii) Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.
ix) whether the financial statements adequately refer to or describe the applicable financial reporting framework

16.5 Types of Audit Reports.

- ➔ Unmodified/ Unqualified.
- ➔ Modified which include: Qualified; adverse and disclaimer of opinion.

1. UNMODIFIED /UNQUALIFIED AUDIT OPINION.

This is a favourable opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The auditor has no reservations whatsoever about the financial reporting and is satisfied that:

(a) Proper books of accounts are kept as per the company's act requirement.
(b) He has received all the information and explanations necessary for the purpose of his audit.
(c) Financial statements prepared are in agreement with the underlying books of accounts.
(d) The financial statements portray a true and fair view of the company's state of affairs.
(e) Adequate returns from the company's branches not visited have been received.

2. MODIFIED REPORTS ISA 705

Modified reports are issued when the auditor has reservations about the financial statements meaning that the auditor is unable to issue an unqualified report.

Circumstances When a Modification to the Auditor's Opinion Is Required

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

- ➔ ***Disagreement:*** The auditor concludes that, based on the audit evidence obtained, the financial statements taken as a whole are not free from material misstatement;
- ➔ ***Limitation of scope***: The auditor was unable to obtain sufficient appropriate audit evidence to enable him to conclude on whether the financial statements as a whole are free from material misstatement.

16.5.1 Basis of Modification

1. **Disagreement:** The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement;

Examples of conditions that may give rise to disagreement

- ➔ The appropriateness of the selected accounting policies
- ➔ The application of the selected accounting policies
- ➔ The appropriateness or adequacy of disclosures in the financial statements.
- ➔ Compliance with accounting standards
- ➔ Amount or value presented in the financial statements.
- ➔ Non-compliance with laws and legislations affecting the financial statements
- ➔ Manner of presentation of the financial statements.

2. **Limitation of scope**: The auditor is unable to obtain sufficient appropriate audit evidence to enable him to conclude on whether the financial statements as a whole are free from material misstatement. Limitation of scoped by the management or may be due to factors the at beyond the management or auditor's control

Factors that are beyond the managements and the auditor's control

- ➔ The entity's accounting records have been destroyed by fire.
- ➔ The accounting records of a significant component have been detained indefinitely by governmental authorities.
- ➔ The timing of the auditor's appointment is such that, the auditor is unable to observe the counting of the physical inventories.
- ➔ The auditor determines that performance of substantive procedures alone is not sufficient, but the entity's controls are not effective

Examples of limitation imposed by the management

- ➔ Management prevents the auditor from observing the counting of the physical inventory.
- ➔ Management prevents the auditor from requesting external confirmation of specific account balances.
- ➔ Management denies the auditor to access records and documents

3. **Basis for Opinion paragraph**

When the auditor modifies the opinion on the financial statements, the auditor should in addition to the specific elements required by ISA 700 the heading "Basis for Opinion" required by ISA 700 (Revised) to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate;

This section should include a description of the matter giving rise to the modification together with reference to the relevant financial reporting standard. It should also include a description and a quantification of the financial effect of the misstatement and if it is impracticable a statement to that effect.

16.5.2 Types of Modified Opinions

ISA 705 identifies three types of modified opinions which include:

- Qualified opinion
- Adverse opinion
- Disclaimer of opinion

Table 16.1 Audit qualification matrix

Nature of Matter Giving Rise to the Modification	Matter is material and not Pervasive	Material and pervasive
Limitation of scope- Inability to obtain sufficient appropriate audit evidence	*Qualified opinion*	*Disclaimer of opinion*
Disagreement- Financial statements are materially misstated	*Qualified opinion*	*Adverse opinion*

Source ISA 705 (2018

☞ ***A PERVASIVE MATTER*** A matter is considered to be pervasive if it is all encompassing, enveloping and persistent in the auditor's judgment implying that:
i.The matter is not confined to specific elements, accounts or items of the financial statements;
ii. If confined, the matter represents a substantial proportion of the financial statements;
iii. In relation to disclosures, the disclosures are fundamental to users' understanding of the financial statements.

Types of modified reports explained

1. QUALIFIED AUDIT OPINION

A qualified report is an unfavorable report given when the auditor has reservations about the clients financial reporting. It is issued when the auditor is unable to issue an unqualified report due to either a disagreement or limitation of scope

A qualified opinion is issued when:

a) There is limitation of scope on a matter that is material but not pervasive. The auditor in this case is communicating to the reader that there may have been possible adjustments with regard to the identified matters but due to limitation of scope, the auditor cannot determine.

b) There is disagreement on a matter that is material but not pervasive. The opinion is communicating that the practical statements give a true and fair view except for a specified item which can be adjusted had there been no disagreement.

2 Disclaimer of opinion

A disclaimer of opinion is a modified report given when there is limitation of scope on a matter that is material and pervasive. The disclaimer is issued due to an inability by the auditor to obtain sufficient appropriate audit. The auditor is communicating that he could not get sufficient evidence to support and consequently unable to express an opinion.

3. Adverse opinion

A modified report is given when there is disagreement on a matter that is material and pervasive, the auditor concludes that the financial statements are totally misleading.

16.6 Emphasis of The Matter Paragraph

An emphasis of Matter paragraph according to ISA 706, is 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 fundamental importance to users' understanding of the financial statements. This paragraph is intended to draw the attention of the users to matters that are material to the financial statement that are appropriately disclosed, which the auditor feels that the user ought to know. Such matters may include

- Matters regarding going concern problems
- Pending legal cases that are highly material that they may affect the future of the company
- Explanation of a new legislation that may have an impact on the financial statements.
- 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.
- Material subsequent events that may affect the future of the company

20.7 Other Matter paragraph

This is a paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements which, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

20.8 Communicating Key Audit Matters in The Independent Auditor's Report

Key audit matters according to ISA 701, are those matters that, in the auditor's professional judgment, were of most significance in the audit of the current period's financial statements. Key audit matters are selected from the matters communicated with those charged with governance.

Communicating Key Audit Matters

The auditor should include a separate section in the auditor's report a section headed "key audit matters" which should include the following:

1) A description of each key audit matter and how the matter was addressed.
2) A reference to the related disclosure(s), if any, in the financial statements.
3) Reference to reasons why auditor determined that the matter is one of most significance, for example, Economic conditions that affected the auditor's ability to obtain audit evidence, for example illiquid markets for certain financial instruments.; New or emerging accounting policies, for example entity-specific or industry-specific matters on which the engagement team consulted within the firm; Changes in the entity's strategy or business model that had a material effect on the financial statements
4) The auditor response to the key audit matters which should include a description of aspects of the auditor's response or approach that were most relevant to the matter or specific to the assessed risk of material misstatement; a brief overview of procedures performed; an indication of the outcome of the auditor's procedures and key observations with respect to the matter,

The section should also state that:

➔ Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period nd

➔ These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters

The auditor should not communicate a matter in the Key Audit Matters section of the auditor's report when the auditor would be required to modify the opinion as a result of the matter.

Illustration Question

You are the audit manager assigned the audit of the financial statements of Himaya Ltd. for the year ended 31 December 2015. You have come across three material items in the course of your audit which need to be concluded in order to form an audit opinion on the financial statements.

Required:

a) In the context of the above scenario, describe the audit work to be performed on the following matters:

i) The allowance for doubtful debts for the current financial year is Sh. 15 million which represents 2.5% of the accounts receivable as at 31 December 2015. The allowance for doubtful debts for the three previous years was 5% of the accounts receivable. The credit controller has advised that the reduction in allowance was due to the measures undertaken to improve on debt collection and credit check procedures.

ii) The director's emoluments amounting to Sh. 70 million during the year have not been disclosed in the financial statements.

iii) Circularization of a debtor owing the company Sh. 68 million had not been done due to what the financial controller justified as "strained relations with the debtor". No cash has been received from the debtor and some documents regarding shipment to the customer are missing.

b)Explain how the three matters outlined in (a) (i) (ii), and (iii) above would impact on the auditor's report, assuming that your best estimate of the appropriate allowance for doubtful debts is Sh. 30 million and that no adjustments had been made in the financial statements in respect of the matters set out in terms (a) (i), (ii) and (iii) above.

Solution

a) Additional work to be performed

i)Provision for bad and doubtful debts.

Audit procedures

1. Discuss with the management the past provisions made and the actual results by making comparisons over time.
2. Discuss with the management their procedures of de riving the estimate.
3. Discuss with the management the assumptions made and assets the reasonableness of the assumptions.
4. Obtain aged debtors analysis to identify the overdue debts.
5. Compare the allowance with the overdue balances to assess its adequacy.
6. Select a sample of debtors and circularize them.
7. Prepare a debtors control account to verify the accuracy of the debtors balances.
8. Recalculate the provision based on the assumption.
9. Use an independent estimate for comparison.
10. Consider the industry practice.
11. Review collection from the debtors after the balance sheet date.

Impact on auditor's report

According to ISA 540, accounting for estimates, the auditor should assess the reasonableness of the estimate included in financial statement. According to him 30m should be the provision of compared to 15mprovided by the company, hence an under provision for 1500.

The matter is material. Hence the matter is due to disagreement on a matter that is material but not pervasive hence according to this give an "except for" qualification.

b) Directors emoluments – related party transactions

Audit procedures

1) Review directors contract of service to determine the directors entitlements i.e. How much and for what.
2) Review the minutes of the Board to confirm authorization of the director's emoluments.
3) Review the attendance of the directors to the Board meetings to confirm they are paid for their contribution.
4) Vouch the payment of the emoluments by inspecting the payment vouchers, the supporting minutes of the board and trace to the Bank statement and the ledger.
5) Check to confirm that the directors are paid NET of WHT.
6) Review the articles of association to determine the director's powers with regard to director's remuneration.

Impact

This is a related party translation IAS 24 which requires that all related party relationships and transactions must be fully disclosed of which the company has not disclosed to the financial statement.

IAS 1 – presentation of the financial requires disclosure of the director's emoluments.

The company's Act and the capital markets authority (laws and legislations) – ISA 250) requires disclosure of the directors emoluments.

on-disclosure is a disagreement on a matte that is material but not pervasive hence an 'except or' qualification will be issued.

udit procedures

1. Review a contract agreement to verify terms of contract.
2. Reconstruct the debtors account to verify the particular debtor using information from the books of original entry to verify outstanding balance.
3. Review correspondences between the debtor and the customer.
4. Review collections after the balance sheet date.
5. Employ professional skeptism as the missing shipment documents and the allegation of the strained relationship could be an indication of mis-appropriation of receipts from the debtors.
6. Obtain written management representations regarding the balance.
7. Review the paying patterns of the debtor in the past.
8. Review the adequacy of the provision for bad debts in relation to this debt.

ıpact

is is limitation of scope on a matter that is material but not pervasive. Had there been no ıitation of scope, probably the auditor would have recommended and adjustment to the ance but of now he can't due to the existing limitation of scope hence, the possible ustment/except for "Qualification would be issued."