ADVANCED AUDIT AND ASSURANCE

CORPORATE LEVEL

Communicating Key Audit Matters in the Independent Auditor's Report – (S.L.Au.S – 701)

Modifications to the Opinion in the Independent Auditor's Report – (S.L.Au.S 705)

by

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Communicating Key Audit Matters in the Independent Auditor's Report – (S.L.Au.S – 701)

S.L.Au.S 701 Communicating Key Audit Matters in the Independent Auditor's Report sets out the auditor's responsibly to communicate key audit matters

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". Key audit matters are selected from matters communicated with those charged with governance.

Reporting on KAMs aims to improve transparency by helping users to understand the most significant issues the auditor faced. This should enhance the communicative value of the auditor's report. KAMs are part of every listed company auditor's report, and can be included by other auditors if needed. KAMs do not constitute a modification of the report or of the opinion. They are a part of the standard report which must be tailored to each company's circumstances

Matters which the auditor may determine to be KAMs include:

- Areas of higher risk of material misstatement, or 'significant risks' identified
- Significant judgements in relation to areas where management made judgements
- The effect of significant events or transactions

The key part of the definition of KAMs above is that these are the most significant matters. Identifying the most significant matters involves using the auditor's professional judgement.

Factors to consider when determining KAMs include:

- The importance of the matter to intended users' understanding, including materiality
- The nature of the underlying accounting policy relating to the matter or the complexity or subjectivity involved
- Any misstatements related to the matter
- The nature and extent of audit effort needed to address the matter
- The nature and severity of difficulties in applying audit procedures, obtaining evidence or forming conclusions, including more subjective judgements
- The severity/seriousness of any control deficiencies

When the Auditor decides on a KAM, following information to be covered in the KAM Section in the Audit Report

a) Why the matter was considered to be one of most significance in the Audit and therefore determined to be a Key Audit Matter
b) How the matter is addressed in the Audit

Example – (Extracted from the Annual Report of Eden Hotel Lanka PLC – 2023/24)

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters

Key audit matter	How our audit addressed the key audit matter
Recoverability of investments in subsidiaries Refer to notes 3.2.1 and 15 of the consolidated financial statements for disclosures of related accounting policies, judgments, estimates and balances. The carrying value of the investments in subsidiaries amounted to Rs. 6,989 Mn as at 31 March 2024. In determining the recoverability of the investments in subsidiaries management considered the impact of the current growth in economic conditions on the operational cash flows of the subsidiaries and had performed sensitivity analysis over their cash flow forecasts. During the year ended 31 March 2024, the Company has not recognised any additional provision for impairment of investments in subsidiaries as the recoverable amounts as per the cashflow projections exceeded the carrying amounts. We focused on this matter because the: ¬ Carrying value of the investments in subsidiaries in the statement of financial position is significant; and Inherently subjective nature of determining the recoverable amounts due to the use of estimates and assumptions.	**Our audit procedures included the following** Our audit procedures included the following: Obtaining an understanding of the process by which management evaluates the recoverability of investments in subsidiaries. Evaluating management's assessment in determining whether there are any indicators that the carrying amount of investments in subsidiaries may not be recoverable. Where impairment indicators were noted by management, satisfying ourselves that the final impairment calculations, including the assumptions used, were approved by senior management; Checking the appropriateness of the selection of the impairment testing technique; Obtaining management's impairment calculations and testing the reasonableness of the key assumptions as detailed below, in respect of the discounted cash flow model used: - Agreeing the forecasted information to management approved budgets and business plans; - Assessing the long-term growth rate by comparing it to the economic forecasts; Testing the reliability of management's projections, by comparing actual results for 2023/ 2024 to the forecasts prepared for 2023/ 2024 in the previous year; Checking the reasonability of the calculation of the discount rate by assessing the cost of capital for the Company and comparable organisations, as well as considering territory specific factors; Checking the mathematical accuracy of the discounted cash flow model

Modifications to the Opinion in the Independent Auditor's Report (S.L.Au.S 705)

Types of Audit Opinions

This can be segregated into two aspects

A) Unmodified Audit Opinion
B) Modified Audit Opinion

A) Unmodified Audit Opinion

The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with applicable financial reporting framework.

The Auditor will express an Unmodified Audit Opinion, when following requirements are satisfied.

1) When the Financial Statements are Free from Material Misstatements. When the Financial Statements are prepared in accordance with Sri Lanka Accounting Standards.

2) When the Auditor obtain Sufficient and Appropriate Audit Evidences

VERY IMPORTANT

AUDITOR WILL GO FOR A MODIFIED AUDIT OPINION WHEN THE ABOVE-MENTIONED REQUIREMENTS ARE NOT SATISFIED.

Examples

"In our opinion, the accompanying financial statements of the Company give a true and fair view of the financial position of the Company as at 31st March 2023, and of their financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards"

"In our opinion, the financial statements present fairly, in all material respect, the financial position of ABC Company as at 31st March 2023 and its financial performance and its cashflows for the year then ended in accordance with Sri Lanka Accounting Standards"

B) Modified Audit Opinion

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

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

2. The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Types of Modified Opinions

Standard establishes three types of modified opinions, namely,

a) A Qualified Audit Opinion

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b) An Adverse Audit Opinion

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c) A Disclaimer of Opinion

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The decision regarding which type of modified opinion is appropriate depends upon:

1) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated, **and**

2) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements

<u>IMPORTANT</u>

"Pervasive effects relate to the scope of the effect which reflects the widespread effect of misstatement.". It is a measure of impact of a misstatement and which goes beyond the Materiality.

There are three types of Pervasive effect.

a) Those that are not confined to specific elements, accounts, or items in the financial statements. (A set of a misstatements, which the impact is not confined (limited) to few assertions, but to several assertions)

b) Those that are confined (limited) to specific elements, accounts or items in the financial statements and present a substantial portion of the financial statements. (A set of misstatements, which the impact is confined (limited) to few assertions, however the impact is so significant to the overall financial statements.

c) Those that relate to disclosures which are fundamental to users' understanding of the financial statements. (When the management have not done the fundamental disclosures, such as disclosures applicable to Going Concern, Related Party, Business Combinations)

IMPORTANT.
When the auditor modifies the opinion on the financial statements the auditor shall include a heading immediately after the opinion paragraph to describe the matter which gives rise to the modification.

A) Qualified Audit Opinion

The auditor shall express a qualified opinion when,

a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

Material Misstatement could arise in respective of,

1) ***The Appropriateness of Selected Accounting Policies***
Eg: Selection of Revenue Recognition Policy not in accordance with SLFRS 15
Eg: Selection of Depreciation Policy not in accordance with LKAS 16

2) ***The Application of a Selected Accounting Policy***
Eg: Inventory that should have been stated at the lower of Cost or NRV, are stating at Cost despite the NRV being lower the cost

3) ***The Appropriateness or adequacy of disclosures in the financial statements***
Eg: Going Concern disclosures are inadequate where there is a Material Uncertainty over the entity's ability to continue as a Going Concern.

b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

The Auditor's inability to obtain sufficient and appropriate audit evidences is also referred as a Scope Limitation of the Audit, that could arise as a result of following

1) ***Circumstances beyond the Entity's Control***
Eg: Accounting Records destroyed due to a nature disaster

2) ***Circumstances relating to the Nature or Timing of the Auditor's work.***
Eg: The timing of the Auditor's appointment, prevent the auditor in observation the Physical Stock Verification

3) ***Limitations imposed by Management***
Eg: Management prevents the Auditor from requesting External Confirmations of Debtors/Creditors

Example for Qualified Opinion for option A

Qualified Opinion

We have audited the financial statements of ABC Company (the company), which comprise the statement of financial position as at March 31, 2024, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, ***<u>except for the effects of the matter described in the Basis for Qualified opinion section of our report,</u>*** the accompanying financial statements give a true and fair view of. (present fairly, in all material respects) the financial position of the Company as at March 31, 2024, and of its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

<u>Basis for Qualified Opinion</u>

The Company's inventories are carried in the statement of financial position at xxx. Management has not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from Sri Lanka Accounting Standards. The Company's records indicate that, had management stated the inventories at the lower of cost and net realizable value, an amount of xxx would have been required to write the inventories down to their net realizable value Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders equity would have been reduced by xxx, xxx and xxx, respectively.

We conducted our audit in accordance with Sri tanka Auditing Standards (SLAUSs).

Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by CA Sri tanka (code of Ethics), and we have fulfilled our other ethical responsibilities in accordance with these requirements.

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

Example for Qualified Opinion for option B

Qualified Opinion

We have audited the financial statements of ABC Company (the company), which comprise the statement of financial position as at March 31, 2024, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, ***<u>except for the effects of the matter described in the Basis for Qualified opinion section of our report</u>***, the accompanying financial statements give a true and fair view of (present fairly, in all material respects) the financial position of the Company as at March 31, 2024, and of its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

Basis for Qualified Opinion

The Company appointed, we as the auditors after the reporting period and therefore, we have not observed the stock count which was carried out by the Company as at 31st March 2024. Due to the incompleteness of the stock records after the reporting period, as auditors we are not in a position to carry out other alternative procedures to validate the accuracy of the stock balance reported in the Statement of Financial Position as at 31st March 2024. Due to the above reasons, as auditors we were unable to obtain sufficient and appropriate audit evidences with regard to the closing inventory.

We conducted our audit in accordance with Sri tanka Auditing Standards (SLAUSs).

Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by CA Sri tanka (code of Ethics), and we have fulfilled our other ethical responsibilities in accordance with these requirements.

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

B) Adverse Audit Opinion

The auditor expresses 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.

Example 01 for Adverse Opinion

Adverse Opinion

We have audited the financial statements of ABC Company (the company), which comprise the statement of financial position as at March 31, 2024, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying financial statements do not present fairly ***do not give a true and fait view of, (do not present fairly)*** the financial position of the Company as at March 31, 2024, and (of) its financial performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

Basis of Adverse Opinion

The Company is having five bank accounts which are using for the operational activities. However, out of the five, in three bank accounts, bank balance appears in the bank statements as at 31st March 2024 is not in line with the bank balance appears in the Bank Reconciliation which has been prepared by the Company as at 31st March 2024. As a result of that, many elements in the accompanying financial statements would have been affected including, revenue, expenses, trade and other receivables, trade and other payables, bank balance and etc.

We conducted our audit in accordance with Sri tanka Auditing Standards (SLAUSs).

Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by CA Sri tanka (code of Ethics), and we have fulfilled our other ethical responsibilities in accordance with these requirements.

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

Example 02 for Adverse Opinion

Adverse Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at March 31, 2024, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying consolidated financial statements do not present fairly (or do not give a true and fair view of) the consolidated financial position of the Group as at March 31, 2024, and (of) its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

Basis for adverse opinion

As explained in Note X, the Group has not consolidated subsidiary XYZ Company that the Group acquired during 2023/24 because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis.

Under Sri Lanka Accounting Standards, the Company should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

We conducted our audit in accordance with Sri tanka Auditing Standards (SLAUSs).

Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by CA Sri tanka (code of Ethics), and we have fulfilled our other ethical responsibilities in accordance with these requirements.

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

C) Disclaimer of Opinion

The auditor disclaims an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

Example for Disclaimer of Opinion

Disclaimer of Opinion

We were engaged to the audit the financial statements of ABC Company, which comprise the statement of financial position as at March 31, 2024, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying financial statements of ABC Company. Because of the significance of the matters described in the Basis of Disclaimer of Opinion section of our report, we have not been able to obtain sufficient and appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

The Company appointed, we as the auditors after the reporting period and therefore, we have not observed the stock count which was carried out by the Company as at 31st March 2024. Due to the incompleteness of the stock records after the reporting period, as auditors we are not in a position to carry out other alternative procedures to validate the accuracy of the stock balance reported in the Statement of Financial Position as at 31st March 2024. In addition, the introduction of a new computerised accounts receivable system in September 2023 resulted in numerous errors in accounts receivable. As of the date of our auditor's report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the statement of financial position at a total amount of xxx as at March 31, 2024. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the statement of profit or loss, statement of changes in equity and cash flow statement.

We conducted our audit in accordance with Sri tanka Auditing Standards (SLAUSs).

Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by CA Sri tanka (code of Ethics), and we have fulfilled our other ethical responsibilities in accordance with these requirements.

The Relationship of KAM with the Auditor's Opinion

If a modified opinion is expressed, the matter that gives rise to the modified opinion will be described in the 'basis for modified opinion' paragraph, so it must not be included as a KAM

Note that where the auditor disclaims an opinion on the financial statements, a Key Audit Matters section must not be included in the auditor's report.

S.L.Au.S 701 also makes special mention of going concern problems, which we have covered previously. Where there is a material uncertainty in relation to going concern, this is described in the 'Material uncertainty related to going concern' section. Going concern issues should not be included as a KAM

Additional Notes.