

Audit report

The auditor's report

The auditor is required to produce an **auditor's report** at the end of the audit which sets out their **opinion** on the truth and fairness of the financial statements. The report contains a number of **consistent elements** so that users know the audit has been conducted according to **recognised standards**.

Auditor's reports are covered by the following SLAuSs:

- SLAuS 700 (Revised) *Forming an Opinion and Reporting on Financial Statements*
- SLAuS 701 *Communicating Key Audit Matters in the Independent Auditor's Report*
- SLAuS 705 (Revised) *Modifications to the Opinion in the Independent Auditor's Report*
- SLAuS 706 (Revised) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

In order to form the opinion, the auditor needs to conclude as to whether reasonable assurance has been obtained that the financial statements are free from material misstatement. The auditor's conclusion needs to consider the following.

- Whether **sufficient appropriate audit evidence** has been obtained (SLAuS 330)
- Whether **uncorrected misstatements are material** (SLAuS 450)
- **Qualitative aspects of the entity's accounting practices**, including indicators of **possible bias** in management's judgements
- Whether the financial statements **adequately disclose the significant accounting policies selected and applied**
- Whether the accounting policies selected and applied are **consistent** with the applicable financial reporting framework and are **appropriate**
- Whether **accounting estimates** made by management are **reasonable**
- Whether **the information** in the financial statements is **relevant, reliable, comparable and understandable**

Unmodified opinions in the auditor's report

An **unmodified opinion** is the 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.

Elements of the auditor's report

Basic elements of audit report	Explanation
Title	<p>The auditor's report must have a title that clearly indicates that it is the report of the independent auditor. This signifies that the auditor has met all the ethical requirements concerning independence and therefore distinguishes the auditor's report from other reports.</p>
Addressee	<p>The addressee will be determined by law or regulation, but is likely to be the shareholders or those charged with governance.</p>
Opinion section	<p>The opinion section must identify the entity being audited, state that the financial statements have been audited, identify the title of each statement that comprises the financial statements being audited, refer to the summary of significant accounting policies and other explanatory notes, and specify the date or period covered by each statement comprising the financial statements.</p> <p>If the auditor expresses an unmodified opinion on financial statements prepared in accordance with a fair presentation framework, the opinion shall use one of the following equivalent phrases:</p> <ul style="list-style-type: none"> • The financial statements present fairly, in all material respects, ...in accordance with [the applicable financial reporting framework]; or • The financial statements give a true and fair view of ... in accordance with [the applicable financial reporting framework].
Basis for opinion	<p>The basis for opinion section must state that the audit was conducted in accordance with the SLAuSs, and refer to the 'Auditor's responsibilities for the audit of the financial statements' section which describes the auditor's responsibilities under the SLAuSs.</p> <p>The auditor must also state that they are independent of the audited entity, in accordance with the relevant ethical requirements relating to the audit.</p> <p>Finally, the auditor must state that they believe the audit evidence obtained is sufficient and appropriate to provide a basis for the audit opinion.</p>

Basic elements of audit report	Explanation
Going concern	Where the auditor considers a material uncertainty related to going concern exists, this should be described in a separate section headed 'Material uncertainty related to going concern'.
Key audit matters	For the audit of listed entities, or where required by law or regulation, the auditor should include a 'Key audit matters' section. This section describes the matters that, in the auditor's professional judgement, are most significant to the audit. (See section below.)
Other information	<p>For the audit of listed entities or any other entity where the auditor has obtained other information, an 'Other information' section should be included in the auditor's report. This section should include:</p> <ul style="list-style-type: none"> • A statement that management is responsible for the other information • An identification of the other information obtained before the date of the auditor's report (for listed entities, also the other information 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 • A description of the auditor's responsibilities for reading, considering and reporting on other information, and • Where other information has been obtained, either a statement that the auditor has nothing to report, or a description of any uncorrected material misstatement
Responsibilities for the financial statements	<p>This part of the report describes the responsibilities of those who are responsible for the preparation of the financial statements. This section should describe management's responsibility including the following:</p> <ul style="list-style-type: none"> • The preparation of the financial statements in accordance with the applicable financial reporting framework; • The implementation of such internal control as are necessary to enable the preparation of financial statements that are free from material misstatement, whether due to error or fraud. • The assessment of the entity's ability to continue as a going concern, the appropriateness of the going concern basis of accounting and adequacy of related disclosures;

Basic elements of audit report	Explanation
Going concern	Where the auditor considers a material uncertainty related to going concern exists, this should be described in a separate section headed 'Material uncertainty related to going concern'.
Key audit matters	For the audit of listed entities, or where required by law or regulation, the auditor should include a 'Key audit matters' section. This section describes the matters that, in the auditor's professional judgement, are most significant to the audit. (See section below.)
Other information	<p>For the audit of listed entities or any other entity where the auditor has obtained other information, an 'Other information' section should be included in the auditor's report. This section should include:</p> <ul style="list-style-type: none"> • A statement that management is responsible for the other information • An identification of the other information obtained before the date of the auditor's report (for listed entities, also the other information 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 • A description of the auditor's responsibilities for reading, considering and reporting on other information, and • Where other information has been obtained, either a statement that the auditor has nothing to report, or a description of any uncorrected material misstatement
Responsibilities for the financial statements	<p>This part of the report describes the responsibilities of those who are responsible for the preparation of the financial statements. This section should describe management's responsibility including the following:</p> <ul style="list-style-type: none"> • The preparation of the financial statements in accordance with the applicable financial reporting framework; • The implementation of such internal control as are necessary to enable the preparation of financial statements that are free from material misstatement, whether due to error or fraud. • The assessment of the entity's ability to continue as a going concern, the appropriateness of the going concern basis of accounting and adequacy of related disclosures;

Basic elements of audit report	Explanation
	<p>Reference shall be made to 'the preparation and fair presentation of these financial statements' (or 'the preparation of financial statements that give a true and fair view') where the financial statements are prepared in accordance with a fair presentation framework.</p>
<p>Auditor's responsibilities for the audit of the financial statements</p>	<p>The report must state that:</p> <ul style="list-style-type: none"> • The auditor's objectives are to obtain reasonable assurance whether the financial statements as a whole are free from material misstatement, and to issue an auditor's report that includes the auditor's opinion; and • Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with the SLAuSs will always detect a material misstatement when it exists. <p>The report must also:</p> <ul style="list-style-type: none"> • Explain that misstatements can arise from fraud or error • Describe the meaning of materiality • Explain that the auditor exercises professional judgement and maintains professional scepticism throughout the audit • Describe the auditor's responsibilities in an audit. <p>The description of the auditor's responsibilities must either be set out in the body of the auditor's report, in an appendix to the auditor's report or by including a specific reference in the body of the auditor's report to such a description on the website of an appropriate authority, where this is permitted by law and regulation.</p>
<p>Other reporting responsibilities</p>	<p>If the auditor is required by law to report on any other matters, this must be done in an additional section entitled 'Report on other legal and regulatory requirements' or otherwise as appropriate.</p>
<p>Name of the engagement partner</p>	<p>The name of the engagement partner should be identified, unless such a disclosure is reasonably expected to lead to a significant personal security threat.</p>

Basic elements of audit report	Explanation
Auditor's address	The location where the auditor practises must be included.
Date of the report	The report must be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements.

Auditor's reports on general purpose and special purpose financial statements

general purpose auditor's report

The guidance set out in SLAuS 700 described above is in relation to audit reports on financial statements prepared in accordance with a **general purpose framework**. These are often referred to generically as general purpose audit reports.

A **general purpose framework** is a financial reporting framework designed to meet the needs of a wide range of users. The financial reporting framework may be a fair presentation framework or a compliance framework. (SLAuS 700)

Special purpose auditor's report

When preparing an audit report on financial statements, prepared in accordance with a special purpose framework, the provisions of SLAuS 700 must be followed. In accordance with SLAuS 800, however, the following additional information must also be included:

- A description of the purpose for which the financial statements are prepared and, if necessary, the intended users. If the notes to the special purpose financial statements already include this information, then the audit report will refer to the note instead.
- If management has a choice of financial reporting frameworks, the section of the audit report which includes an explanation of management's responsibility for the financial statements must also make reference to its responsibility for determining that the applicable financial reporting framework is acceptable.
- An emphasis of matter paragraph, alerting users of the audit report to the fact that the financial statements are prepared in accordance with a special purpose framework and, as a result, may not be suitable for other purposes.

Key audit matters

SLAuS 701 *Communicating Key Audit Matters in the Independent Auditor's Report* sets out the auditor's responsibility to communicate key audit matters (KAMs).

Key Audit Matters '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. KAMs are not a substitute for disclosures, for EoM/OM paragraphs, nor for modified opinions. Matters which the auditor may determine to be KAMs include:

- Areas of **higher risk** of material misstatement, or 'significant risks' identified in line with SLAuS 315 (eg at the planning stage)
- **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**.

- Other 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 of any **control deficiencies**

KAMs are communicated in a separate paragraph of the auditor's report. The description of each KAM says **two main things**:

SLAuS 70

The description of each key audit matter in the Key Audit Matters section of the auditor's report shall include a reference to the related disclosure(s), if any, in the financial statements and shall address:

- (a) Why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter; and
- (b) How the matter was addressed in the audit.

Here is an example of how KAMs could appear, taken from the IAASB's guidance publication *Auditor Reporting – Illustrative Key Audit Matters*:

Key Audit Matters

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.**

Goodwill

Under SLAuSs, the Group is required to **annually test the amount of goodwill for impairment.** This annual impairment test was significant to our audit because the balance of XX as of December 31, 20X1 is **material to the financial statements.** In addition, management's assessment process is complex and highly judgmental and is based on assumptions, specifically [describe certain assumptions], which are affected by expected future market or economic conditions, particularly those in [name of country or geographic area].

Our audit procedures included, among others, using a **valuation expert** to assist us in evaluating the **assumptions and methodologies used by the Group,** in particular those relating to the **forecasted revenue growth and profit margins** for [name of business line]. We also focused on the adequacy of the Group's disclosures about those **assumptions** to which the outcome of the impairment test is most sensitive, that is, those that have the most significant effect on the determination of the **recoverable amount of goodwill.**

Relationship with the auditor's opinion

The KAMs are the key matters for the audit of the whole financial statements. They are **not** separate auditor's opinions for each part of the financial statements, but merely further information on the process that led up to the opinion on the financial statements as a whole. Likewise, the auditor's opinion refers to the financial statements as a whole: as a whole they might give a true and fair view, or as a whole they might be true and fair 'except for' one area (and so on).

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 (although the KAM section will include a reference to the 'basis for modified opinion paragraph) SLAuS 701 emphasises this:

The auditor shall 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 in accordance with SLAuS 705 (Revised) as a result of the matter.

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.

SLAuS 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** (although the KAM section will include a reference to the 'Material uncertainty related to going concern section).

Relationship with Emphasis of Matter and Other Matter paragraphs

There is potentially some degree of overlap between matters which could be disclosed as KAMs or in an EoM paragraph. Where SLAuS 701 applies, SLAuS 706 states that the use of an EoM is not a substitute for a description of individual key audit matters. In other words if the matter meets the definition of a KAM it should be disclosed as such. Where a KAM is also judged to be fundamental to the users' understanding of the financial statements the auditor may wish to highlight its relative importance. This could be done, for example, by presenting the matter as the first matter in the KAM section. If a matter is not determined to be a KAM but is fundamental to the users' understanding and the auditor wishes to draw attention to the matter it should be disclosed in the EoM paragraph.

A similar principle applies to the potential overlap between matters that may be included as 'Other Matters'. SLAuS 706 states that the matter must be included in an 'Other Matter' paragraph provided, where SLAuS 701 applies, the matter has not been determined to be a KAM.

Emphasis of matter paragraphs and other matter paragraphs in the auditor's report

Emphasis of matter paragraphs and **other matter paragraphs** can be included in the auditor's report under certain circumstances. Their use does not modify the auditor's opinion on the financial statements

SLAuS 706 (Revised) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* provides guidance to auditors on the inclusion of paragraphs in the auditor's report that either draw users' attention to a matter that is of such importance that it is fundamental to their understanding or that is relevant to their understanding of the audit, the auditor's responsibilities or the auditor's report.

Emphasis of matter paragraphs

An **emphasis of matter paragraph** 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 judgement, is of such importance that it is fundamental to users' understanding of the financial statements.

Emphasis of matter paragraphs are used to draw readers' attention to a matter **already presented or disclosed** in the financial statements that the auditor feels is **fundamental** to their understanding, provided that the auditor has obtained sufficient appropriate audit evidence that the matter is **not materially misstated**. Note that an emphasis of matter paragraph is **not used** when the issue has been covered as a **key audit matter**.

Where there is a Key Audit Matters section, the emphasis of matter paragraph can come either before or after the KAMs, depending on how significant the matters discussed is. The paragraph must contain a **clear reference** to the matter being emphasized and to where relevant disclosures that fully describe it can be found in the financial statements. The paragraph must state that **the auditor's opinion is not modified** in respect of the matter emphasised. In addition, the paragraph must clearly state that the audit opinion is not modified.

The following are examples of situations in which the auditor might include an emphasis of matter paragraph in the auditor's report.

- An uncertainty relating to the future outcome of **exceptional litigation or regulatory action**
- A significant subsequent event which occurs between the date of the financial statements and the date of the auditor's report
- **Early application of a new accounting standard** that has a **pervasive effect** on the financial statements
- A **major catastrophe** that has had, or continues to have, a **significant effect** on the entity's financial position

SLAuS 706 (Appendix 3) contains an example auditor's report that contains an emphasis of matter paragraph, relevant extracts of which are shown below.

'Emphasis of Matter

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.'

1.5.2 Other matter paragraphs

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

Other matter paragraphs are used where the auditor considers it necessary to draw readers' attention to a matter that is relevant to their understanding of the audit, the auditor's responsibilities or the auditor's report.

The other matter paragraph can be used whenever the auditor judges the matter to be relevant to users' understanding of the audit. Examples include:

- The auditor is unable to withdraw from the engagement and yet is unable to obtain sufficient appropriate audit evidence;
- The auditor has been requested to report on other matters or to provide more clarifications in line with the legal jurisdiction of the country.

An other matter paragraph must not refer to something that has been included as a key audit matter.

The following is an example of an Other Matter paragraph, taken from the appendix to SLAuS 710.

Other Matter

The financial statements of ABC Company for the year ended December 31, 20X0, were audited by another auditor who expressed an unmodified opinion on those statements on March 31, 20X1.

Modified opinions in the auditor's reports

There are three types of **modified opinion**: a **qualified opinion**, an **adverse opinion**, and a **disclaimer of opinion**.

SLAuS 705 *Modifications to the opinion in the independent auditor's report* sets out the different types of modified opinions that can result. It identifies three possible types of modifications:

- A **qualified** opinion
- An **adverse** opinion
- A **disclaimer** of opinion

Types of modifications

Pervasiveness is a term used to describe the effects or possible effects on the financial statements of misstatements or undetected misstatements (due to an inability to obtain sufficient appropriate audit evidence). There are three types of pervasive effect:

- Those that are not confined to specific elements, accounts or items in the financial statements
- Those that are confined to specific elements, accounts or items in the financial statements and represent or could represent a substantial portion of the financial statements
- Those that relate to disclosures which are fundamental to users' understanding of the financial statements

The type of modification issued depends on the following:

- The **nature of the matter** giving rise to the modifications (ie whether the financial statements **are materially misstated**, or whether they **may be misstated** when the auditor cannot obtain sufficient appropriate audit evidence)
- The auditor's judgement about the **pervasiveness** of the effects/possible effects of the matter on the financial statements

A modified opinion is required when:

- The auditor concludes that the financial statements as a whole are not free from material misstatements or
- The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Pervasiveness

When considering whether a matter is pervasive we have seen, in the definition in 2.1, that there are three tests as to whether a material misstatement is pervasive:

(1) Material misstatements or omissions are not confined to specific elements, accounts or items in the financial statements

This is where multiple account areas are impacted by the misstatement. An example may be where the results and assets of a division of a company have not been included in the financial statements, resulting in understatement of assets, liabilities, revenues, costs and profit.

(2) A material misstatement (or misstatements) only impacts on one area of the financial statements but represents (or could represent) a substantial proportion of the financial statements

This is where the misstatement of the area of the financial statement affected is very material and therefore has a significant impact on users, despite being confined to one element. For example, imagine a company owning investment property. The key balance a shareholder will consider will be the value of the property shown on the statement of financial position. If there is a material misstatement such that that the property is shown at, for example, double its true value as required by Sri Lanka Accounting Standards – this misstatement would be pervasive.

(3) Material misstatements or omissions relate to disclosures which are fundamental to users' understanding of the financial statements

The most common example of this is where disclosures in relation to going concern are misleading or missing. Such disclosures can be essential to the users' understanding, when the going concern basis is threatened.

Qualified opinions

A qualified opinion must be expressed in the auditor's report in the following two situations:

(1) The auditor concludes that misstatements are material, but not pervasive, to the financial statements.

Material misstatements could arise in respect of:

- The appropriateness of selected accounting policies (for example, selecting a revenue recognition policy not in accordance with LKAS 18).
- The application of selected accounting policies (for example, inventory that should be stated at the lower of cost and net realizable value (NRV) per the accounting policy has all been valued at cost despite NRV being lower for some lines of inventory).
- The appropriateness or adequacy of disclosures in the financial statements (for example, going concern disclosures are inadequate where there is a material uncertainty over the entity's ability to continue as a going concern).

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

The auditor's inability to obtain sufficient appropriate audit evidence is also referred to as a limitation on the scope of the audit, and could arise from:

- Circumstances beyond the entity's control (eg accounting records destroyed)
- Circumstances relating to the nature or timing of the auditor's work (eg the timing of the auditor's appointment prevents the observation of the physical inventory count)
- Limitations imposed by management (eg management prevents the auditor from requesting external confirmation of specific account balances)

Adverse opinions

An adverse opinion is expressed when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements are both **material and pervasive** to the financial statements. The table below gives one example of why an adverse opinion might be expressed for each of the three possible reasons for misstatements being determined as pervasive.

Adverse opinions, and reasons for them

Reason deemed pervasive	Example
Misstatements are not confined to specific elements, accounts or items in the financial statements	No depreciation has been provided on plant and equipment, a receivable balance consisting half of total receivables is irrecoverable and has not been provided and trade payables have been significantly understated. All misstatements are material and these balances are significant in the statement of financial position.
Misstatements are confined to specific elements, accounts or items in the financial statements and represent a substantial portion of the financial statements	A house building company has included all the houses it has constructed in the year as noncurrent assets rather than inventory. The value of these houses constitutes 90% of the total asset value on the statement of financial position.
Misstatements relate to disclosures which are fundamental to users' understanding of the financial statements	There is a material uncertainty in respect of going concern which has not been adequately disclosed

Disclaimers of opinion

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

The opinion must also be disclaimed in situations involving **multiple uncertainties** when the auditor concludes that, despite having obtained sufficient appropriate audit evidence for the individual uncertainties, it is not possible to form an opinion on the financial statements due to the **potential interaction of the uncertainties and their possible cumulative effect** on the financial statements.

One example of when a disclaimer of opinion is used was given in Chapter 14 where, in relation to going concern, management is unwilling to make or extend its assessment. Another example might be where the auditor is unable to attend the inventory count and unable to request receivable confirmations, and there is no other realistic means of gathering evidence on these two areas. If these two areas form a significant element of the total assets value, a disclaimer may be appropriate.

Impact on the auditor's report

When the auditor has had to modify the auditor's opinion, the auditor's report must include a paragraph after the opinion paragraph, which provides a description of the matter giving rise to the modification. This paragraph will be entitled 'Basis for qualified opinion' or 'Basis for adverse opinion' or 'Basis for disclaimer of opinion' depending on the type of modification

The section of the auditor's report containing the opinion will be headed either 'Qualified opinion', 'Adverse opinion' or 'Disclaimer of opinion', again depending on the type of modification.

When the auditor expresses a qualified or adverse opinion, the section of the report on the auditor's responsibilities must be amended to state that the auditor believes that the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's modified audit opinion.

When the auditor disclaims an opinion due to being unable to obtain sufficient appropriate audit evidence, the section on the auditor's responsibilities must be amended to include the following 'Because of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.'

We will now look at some examples of extracts from auditors' reports with modified opinions for each of the situations we have discussed above.

Example 1: Qualified opinion due to material misstatement In this example, inventories are materially misstated but the effect is not pervasive.

Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, 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, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of ABC Company as at December 31, 20X1, 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's inventories are carried in the statement of financial position at xxx. Management has not stated inventories at the lower of cost and net realisable 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 realisable value, an amount of xxx would have been required to write the inventories down to their net realisable 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 Lanka Auditing Standards. 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 Group in accordance with the Code of Ethics issued by CA Sri Lanka (CA Sri Lanka Code), 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 2: Adverse opinion due to material misstatement with a pervasive effect

This example is an adverse opinion due to a pervasive material misstatement in the consolidated financial statements.

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 December 31, 20X1, 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 December 31, 20X1, 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 20X1 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.

Example 3: Qualified opinion due to inability to obtain sufficient appropriate audit evidence

In this example, the inventory count was not attended by the auditor, but, in the context of the financial statements, even though inventory could be materially misstated (which the auditor cannot conclude on – so the phrase 'possible effects' is used), the effects would not be pervasive.

Qualified 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 December 31, 20X1, 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, except for the possible effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying consolidated financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of the Group as at December 31, 20X1, 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 qualified opinion

With respect to inventory having a carrying amount of \$X the audit evidence available to us was limited because we did not observe the counting of the physical inventory as at 31 December 20X1, since that date was prior to our appointment as auditor of the company. Owing to the nature of the company's records, we were unable to obtain sufficient appropriate audit evidence regarding the inventory quantities by using other audit procedures.

Example 4: Disclaimer of opinion due to inability to obtain sufficient appropriate audit evidence about multiple elements of the financial statements

In this example, the auditor has not only been unable to attend the inventory count, but has also been unable to gain evidence over other areas. As a result, the auditor has concluded that the effects of the possible misstatements could be material and pervasive.

Disclaimer of Opinion

We were engaged to audit the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, 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.

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

Basis for disclaimer of opinion

We were not appointed as auditors of the company until after December 31, 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at December 31, 20X0 and 20X1 which are stated in the statement of financial position at xxx and xxx, respectively. In addition, the introduction of a new computerised accounts receivable system in September 20X1 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 December 31, 20X1. 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.

Communication with those charged with governance

SLAuS 705 states that when the auditor expects to express a modified opinion, the auditor must **communicate with those charged with governance** the circumstances leading to the expected modification and the proposed wording of the modification in the auditor's report.

This allows the auditor to give **notice** to those charged with governance of the intended modification and the reasons for it, to **seek agreement or confirm disagreement** with those charged with governance with respect to the modification, and to give those charged with governance an **opportunity to provide further information and explanations** on the matter giving rise to the expected modification.

Other information in documents containing the auditor's Report

Auditors shall review the **other information** to determine whether there are any material inconsistencies or whether other information is materially misstated.

SLAuS 720 (Revised) *The Auditor's Responsibilities Relating to Other Information* provides guidance to auditors in this area. The objective of the auditor is to respond appropriately when documents containing audited financial statements include other information that could **undermine the credibility** of the financial statements and the auditor's report.

Other information is financial or non-financial information (other than the financial statements and the auditor's report thereon) included in an entity's annual report.

An **annual report** is a document, or combination of documents, prepared typically on an annual basis by management or those charged with governance in accordance with law, regulation or custom.

Its purpose is to provide owners (or similar stakeholders) with information on the entity's operations and the entity's financial results and financial position as set out in the financial statements.

A **misstatement of the other information** exists when the other information is incorrectly stated or otherwise misleading (including because it omits or obscures information necessary for a proper understanding of a matter disclosed in the other information).

Examples of other amounts or other items that may be included as other information are as follows:

- Overview of strategy
- Financial summaries or highlights
- Planned capital expenditures
- Financial ratios
- Explanations of critical accounting estimates and related assumptions

Material misstatements of the other information

SLAuS 720 states that the auditor shall **read** the other information to identify **material inconsistencies** with the audited financial statements. If a material inconsistency is identified, the auditor shall determine whether the audited financial statements or other information is **misstated**.

If the **financial statements** are materially misstated but management refuses to correct the misstatement, the auditor shall **modify** the audit opinion.

If the **other information** is materially misstated and needs to be revised but management refuses, the auditor shall **communicate** this matter to those charged with governance and:

- Consider the implications for the auditor's report, or
- **Withdraw** from the engagement (where this is legally permitted).

In reading and considering the other information, the auditor should also consider whether the auditor's understanding of the entity and its environment needs to be updated.

Reporting

The auditor's report will always include a separate Other Information section when the auditor has obtained some or all of the other information as of the date of the auditor's report. For listed entities, the section is also included if other information is expected to be received after the date of the auditor's report.

The Other Information section is placed after the Key Audit Matters section and where the other information is not materially misstated it would be worded as follows:



Other information

Management is responsible for the other information. The other information comprises the [information included in the X report, but does not include the financial statements and our auditor's report thereon.]

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

If the auditor concludes that there is a material misstatement of the other information, the 'Other Information' section is placed immediately after the basis of opinion section. It will state:

As described below, we have concluded that such a material misstatement of the other information exists.

This statement is followed by a description of the misstatement.

