# Chapter 2
## Audit Report and its Elements
Full chapter infographic: LO 1 to LO 6

## 1 Standard elements of the audit report

### 1 Title
- Must say "Independent Auditor's Report"
- Distinguishes it from Director's or Internal Auditor's report

### 2 Addressee
- Statutory audit: members (shareholders)
- Non-statutory: Board of Directors

### 3 Opinion (most important)
- Identifies entity, F/S audited, period covered
- States whether F/S prepared under AFRF and give a true and fair view

### 4 Basis for opinion
- Comes right after the opinion; explains why the opinion is valid
- Audit done per ISAs; independent and ethical; sufficient appropriate evidence

### 5 Management responsibilities
- Prepare F/S under the framework
- Design internal controls against material misstatement
- Assess going concern
- TCWG oversee financial reporting

### 6 Auditor responsibilities
- Reasonable assurance F/S are free from material misstatement; issue report with opinion
- Risk assessment, procedures, evidence, internal control (no opinion on it), policies and estimates, going concern, overall presentation

### Auditor communicates with TCWG
- Audit scope and timing
- Significant findings
- Ethical independence compliance (listed entities)
- Key Audit Matters

### Location of responsibilities text
- In the main report body
- In an appendix (with reference)
- On a relevant authority's website, if law allows

### 7 Other legal requirements
- Report has 2 sections: audit of F/S, and other legal requirements
- Pakistan (Companies Act): books kept; F/S agree with books; investments, expenditure, guarantees for company business; zakat deducted and deposited

### 8 Signature and name
- In audit firm name, personal name, or both (per jurisdiction)
- Listed entity: engagement partner's name too

### 9 Date of report
- On or after the date the Board approves the F/S
- Shows auditor considered subsequent events up to that date

### 10 Address
- City of the office that conducted the audit

### 11 UDIN
- 20-digit number issued by ICAP
- Confirms report signed by an authorized practicing member

## 2 Key Audit Matter (KAM)

### What is a KAM?
- Matters of most significance in the audit of current period F/S, in auditor's professional judgment
- Always selected from matters communicated with TCWG

### When is the KAM section included?
- Listed companies: always
- Unlisted: only if required by law, or auditor considers it necessary (public interest entity: bank, insurer, pension fund, charity)
- Disclaimer of opinion: no KAM section

### How determined (2 steps)
1. Identify matters discussed with TCWG
2. Choose those needing most auditor attention

### Factors considered
- Higher risk of material misstatement (ISA 315)
- Significant management judgment, high estimation uncertainty
- Significant or unusual events and transactions
- Complex accounting policies or changes
- Importance to users
- Audit effort: specialists, outside consultation
- Control deficiencies; significant related party transactions

### Common examples
- Revenue
- Goodwill, intangibles, deferred tax
- Revalued assets (property, investments, inventory)
- Impairment of assets
- Financial liabilities valuation
- Acquisitions, disposals, restructuring
- Litigation and tax contingencies
- Related party transactions

### Communicating KAMs
- Heading "Key Audit Matters" with subheading for each
- State the matter and refer to disclosures
- Explain why it was significant
- Describe how it was addressed
- Never imply a separate opinion on KAMs

### Not communicated if
- Law prohibits public disclosure (e.g. ongoing investigation)
- Rare case: negative consequences outweigh public interest benefit

### KAM and modified opinions
- Qualified, adverse or going concern uncertainty is by nature a KAM
- Refer to the Basis section; do not duplicate
- Wording: "In addition to the matter described in the Basis for Qualified Opinion..."

### No KAMs, and documentation
- Still include section: "We have determined that there are no key audit matters to communicate"
- Document matters needing attention, why KAM or not, and talk to TCWG

## 3 Modified opinions and related paragraph

### First evaluate 2 things
- Is there a misstatement or a scope limitation?
- Is the effect immaterial, material or pervasive?

### Immaterial, material, pervasive
- Immaterial = not material
- Material = could influence users' economic decisions (size and nature)
- Pervasive = not confined to specific items, substantial proportion of F/S, or fundamental to users' understanding of disclosures

### Misstatement types
- Inappropriate accounting policies
- Incorrect application of policies
- Inadequate disclosures

### Scope limitation causes
- Beyond entity's control: records destroyed, seized
- Auditor's work: appointed late for inventory count, no associate information, weak controls
- Imposed by management: no count, no confirmations, no written representations

### 4 types of opinion (only one per report)

| Issue | Not material | Material | Material and pervasive |
|---|---|---|---|
| **Misstatement** | Unmodified opinion | Qualified opinion | Adverse opinion |
| **Scope limitation** | Unmodified opinion | Qualified opinion | Disclaimer of opinion |

### Exam tip
- Describe the nature of misstatement or scope limitation in the "Basis for Opinion" paragraph

### Qualified opinion wording
- "except for the effects of the matter described in the Basis for Qualified Opinion"

### Adverse opinion wording
- F/S do not give a true and fair view

### Disclaimer wording
- "We do not express an opinion"; heading Basis for Disclaimer of Opinion; "we were engaged to audit"

## 4 Emphasis of Matter (EOM) paragraph

### Meaning
- Draws attention to a matter in the F/S that is fundamental to users' understanding
- Relates to F/S

### Conditions
- Not a misstatement or scope limitation (ISA 705)
- Not a Key Audit Matter (ISA 701)

### Presentation
- Separate section, heading "Emphasis of Matter"
- State matter, refer to the note, confirm opinion is not modified
- Placement: right after Basis for Opinion; with KAMs, before or after them

### When EOM is used
- Material uncertainty about litigation or regulatory action
- Significant subsequent event
- F/S re-issued or restated
- Major disaster affecting financial position
- Early application of a new standard with material effect
- Framework unacceptable but prescribed by law
- Special purpose framework
- Going concern not appropriate and liquidation basis used

## 5 Other Matter (OM) paragraph

### Meaning
- Draws attention to a matter NOT in the F/S but relevant to users' understanding of the audit, auditor's responsibilities or the report
- Relates to audit

### Conditions
- Not prohibited by law, regulation or standards
- Not a Key Audit Matter

### Circumstances
- Prior period F/S unaudited or audited by another auditor
- More than one set of F/S (general and special purpose)
- Report distribution restricted
- Pervasive scope limitation by management and withdrawal not possible (OM in addition to Disclaimer)

### Presentation
- Separate section, heading "Other Matter"
- If KAMs are present, adjust heading (e.g. "Other Matter - Scope of the Audit") so it is not confused with KAM

## 6 Going concern status

### Meaning
- Entity continues to operate in the foreseeable future, at least 12 months after the reporting date
- Material uncertainty: must be disclosed in F/S
- Assumption not appropriate: use an alternative basis (e.g. liquidation)

### Auditor's procedures
- Evaluate events or conditions casting significant doubt
- Check management's assessment: covers at least 12 months, all relevant information, realistic assumptions and plans
- No assessment: inquire basis of going concern
- Beyond the period: inquire about further events and stay alert; ask management to consider significant ones

### Financial conditions casting doubt
- Substantial operating losses, negative equity or net liabilities
- Negative operating cash flows
- Defaults on loans, arrears of dividends
- Adverse financial ratios, inability to repay debts

### Operating conditions
- Intention to liquidate or cease
- Loss of key management or major customer
- Franchise or supplier loss, labor disputes
- Shortage of supplies, strong competitor

### Legal and external conditions
- Non-compliance with laws
- Changes in law or policy with negative impact
- Pending litigation or regulatory cases
- Uninsured disasters
- Significant delay in approving F/S: inquire reason

### Additional procedures when doubts exist
1. Evaluate management's plans; get written representations
2. Review cash flow forecasts
3. Consider subsequent events
4. Read minutes of directors and shareholders
5. Review loan agreements and regulator reports
6. Inquire of legal counsel
7. Confirm borrowing facilities (e.g. support from parent)

### Effect on the audit report

| Conclusion | Effect on audit report |
|---|---|
| **Appropriate, no material uncertainty** | Unmodified opinion; may include a KAM |
| **Appropriate, material uncertainty exists, disclosure adequate** | Unmodified opinion with "Material Uncertainty Related to Going Concern" paragraph; refer to note; opinion not modified |
| **Appropriate, material uncertainty exists, disclosure inadequate** | Qualified opinion (material) or Adverse opinion (pervasive) |
| **Not appropriate, F/S still on going concern basis** | Adverse opinion |
| **Not appropriate, F/S on alternative basis (liquidation)** | Unmodified opinion with Emphasis of Matter highlighting the alternative basis |
| **Management refuses to make or extend assessment** | Qualified opinion or Disclaimer of opinion |

### Communicate with TCWG
- Do events indicate material uncertainty?
- Is the going concern assumption appropriate?
- Are disclosures adequate?
- Implications for the audit report