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In Focus – Accounting and Auditing

New Audit Report - Comprehensive but Lengthy Analysis - SA 700 and SA 720

With changing times and reducing attention span of the readers it was a necessity to review the form and content of the audit report. The audit report caters to a number of users and these include educated/highly sophisticated investors and also retail investors who may have a limited understanding of regulatory requirements etc. Audit report is an important element of the audit process which communicates the audit opinion to a wide range of users and it is important that its utility to the user is of the highest value.

The Institute of Chartered Accountants of India (ICAI) has been on a constant endeavour to upgrade the auditing standards and benchmark them with the global standards. The new changes have transformed and upgraded the audit report to global standards.

In light of this a number of auditing standards have been revised in line with the global standards.

<i>Standards</i>	<i>Key Change</i>	<i>Effective date</i>
SA 700 (revised) Form an opinion on financial statements	New structure of audit report	1st April 2018
SA 701 Communicating key audit matters in independent auditor's report	New standard which deals with auditor's responsibility to communicate key audit matters	1st April 2018
SA 705 Modifications to the opinion in independent auditor's report	Revised to clarify the impact of new reporting requirements pursuant to changes in SA 700 and introduction of 701	1st April 2018

<i>Standards</i>	<i>Key Change</i>	<i>Effective date</i>
SA 706 Emphasis of matters paragraph and other matters paragraph in independent auditors report	Revised to clarify the impact of new reporting requirements pursuant to changes in SA 700 and introduction of 701	1st April 2018
SA 260 (revised) Communication with those charged with governance	Revised mainly due to introduction of standard on key audit matters. Also there are other changes in standards like communicating the use of experts by the auditor etc.	1st April 2017/ Changes related to KAM are effective from 1st April 2018
SA 570 (revised) Going Concern	Requires a separate section to be included in the auditor's report when the auditor concludes that a material uncertainty related to going concern exists and it has been adequately disclosed in the financial statements	1st April 2017
SA 720 (revised) The auditor's responsibility relating to other information	New reporting requirement relating to other information in financial statements	1st April 2018

Further consequential changes have also been made to SA 210, 220, 230, 510, 540, 600 and 710.

In this articles we focus on the analysis of two auditing standards which have been revised

- Standard on Auditing – SA 700 (revised)
- Standard on Auditing – SA 720 (revised)

Key changes

- *Start with the audit opinion* – Earlier the audit opinion was mentioned after auditor's responsibility para and hence was getting lost in the middle of a lot of technical literature about management responsibility, auditor's responsibility etc. This change will be very useful for the investor as they need not read the full report to understand the auditor's opinion. This is all the more relevant considering the reducing attention span of the readers of the audit report.

- *Clarity in terms on management responsibility and auditor's responsibility on going concern* – With rising number of companies filing for insolvency proceedings under insolvency code. This para is of paramount importance to the auditors as well as the investors for their understanding of the responsibility of the management and the auditors.

- *Affirmative statement on other matters in annual report* – This is an important change which is brought about by SA 720 (revised) and would ensure that auditors carefully read the other aspects of the annual report and comment in case there is any misstatement or contradiction in the items other than financial statements which are also part of the annual report.

Benefits from readers/investors perspective

- **Transparency** - The audit opinions would no longer be binary opinion of yes or no. The new format provides the reader to understand the journey of the audit including the materiality level used, key audit issues and how they were dealt with by the auditors. This would provide the readers an insight about the entire process and thereby making it more transparent.
- **Comfort on consistency of information in annual report** – The very fact that the auditors have to comment on the other matters dealt with in the annual report provides a comfort to the readers about the overall consistency between the annual report and financial statements.
- **Effectiveness of the audit reports** – The new design of audit report is aimed at making the report more effective and self-explanatory. The changes have been made present considering the evolving legal requirement, economic environment, and needs of the users to ensure that audit reports remain effective and relevant from the investor's perspective.

We now analyse both these revised standards in detail:

(SA) 700 (Revised) Forming an opinion and Reporting on Financial statements

A. Overview and applicability

SA 700 (revised) deals with the auditor's responsibility to form an opinion on the audited financial statements and content of the audit report. It gives the fundamental principles and guidelines of reporting.

SA 700 (revised) is effective for audits of financial statements for the period beginning on or after 1st April 2018. This revised SA is not applicable to

audit report signed after 1st April 2018 pertaining to financial statements for periods beginning before 1st April 2018.

This SA applies to an audit of a complete set of general purpose financial statements. General purpose financial statements are those that are prepared in accordance with a 'general purpose financial reporting framework', which is a framework designed to meet the common financial information needs of a wide range of users. This SA applies to audits of complete set of 'financial statements'.

There are other SAs which give detailed guidance on the elements of the audit report e.g., reporting of key audit matters, other information, emphasis of matter & other matters and modified opinion.

ICAI has also issued Implementation Guide for SA 700 (revised) Implementation guide has addressed certain key issues in question answer format.

Reports under different types of engagement

- When financial statements are prepared in accordance with a special purpose framework and in an audit of a single financial statement or of a specific element, account or item of a financial statement; though the reporting principles and structure is based on SA 700 (revised), there are separate SAs for guidance on issue of reporting under such circumstances. It states that auditor shall apply the requirements in SA 700 (revised), adapted as necessary in the circumstances of the engagement.
- Reporting format for report on internal financial control (IFC) over financial reporting also is derived based on SA 700 (revised). Since the illustration as per guidance note on IFC has not been

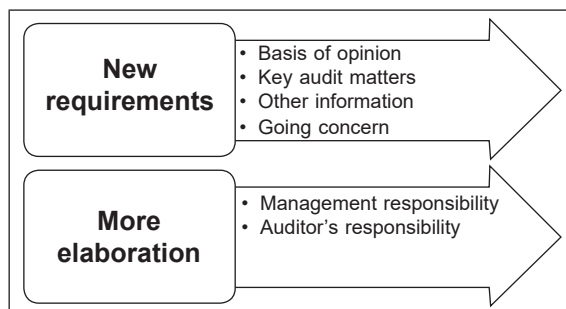
changed, one can take a view that format of IFC report is not required to be changed. Alternatively, as a better practice, there is no harm in changing the format of IFC report in line with SA 700 (revised).

- SA 700 (revised) is not applicable in case of engagements like reviews, compilation or agreed upon procedures. Therefore, format of review report (e.g., limited review report in case of quarterly results of listed companies where format is prescribed by SEBI) is not required to be changed as per SA 700 (revised).

B. Revised structure of the audit report is as under

- Title
- Addressee
- Auditor's opinion
- Basis for opinion
- Going concern, where applicable
- Key audit matters
- Other information, where applicable
- Management responsibilities for the financial statements
- Auditor's responsibilities for the audit of the financial Statements
- Other reporting responsibilities
- Signature of the auditor
- Place of signature
- Date of the auditor's report

Some of the elements mentioned above are new requirements and in few cases there is more elaboration. This is explained by the chart below:



C. Analysis of the elements of the audit report

1. Addressee

The auditor's report is addressed to those for whom it is prepared. Examples are given below:

- In case of company – it should be addressed to members of company
- In case of partnership firm/limited liability partnership – it should be addressed to partners

2. Opinion paragraph & Basis of Opinion

- Sequence of the paragraphs have changed. Now audit report begins with the Opinion paragraph followed by the Basis of Opinion paragraph so that user's attention is attracted to the most relevant part of the audit report.
- Basis of Opinion paragraph is also required to be given when there is an unmodified opinion and it includes the following:
 - o Audit is conducted in accordance with the SAs and whether the audit evidence obtained is sufficient and appropriate to provide a basis for the opinion.

- o Affirmative statement that the auditor is independent of the entity.
- o Auditor has fulfilled the other relevant ethical responsibilities relating to the audit which includes the Code of Ethics issued by the ICAI and ethical requirements under the provisions of the Companies Act, 2013 and the Rules thereunder.

3. *Going concern*

- A new paragraph on management responsibility for assessment of going concern and also auditor's responsibility has been added in the respective sections.
- In cases where there is a material uncertainty as regards going concern a separate paragraph has to be added. This requirement was already applicable through revised SA 570 from financial year 2017-18; however the same is now incorporated in SA 700 (revised) to ensure consistency.
- It is not necessary for all entities to have separate paragraph on going concern. It is only where in auditor's judgment, where there is a material uncertainty that casts a significant doubt on the ability of an entity to continue as a going concern and disclosure in the financial statements are adequate in accordance with SA 570 (revised).

4. *Key audit matters (KAM)*

- These are matters that were of most significance in auditor's judgment in the audit of the financial statements of the current period. Auditor has

to describe the key audit matter and mention audit procedures followed in respect of these matters.

- New SA 701 deals with the guidance on how to report on KAM.
- It is compulsory in case of listed entities or in case of unlisted entities it is voluntary i.e., where the auditor believes that such matters are required to be reported.

5. *Other information in annual report*

- These are the information which are included in the annual report of the company e.g., Board of directors report and annexures thereto, management discussion and analysis, corporate governance, etc.
- SA 720 (revised) deals with the guidance on how to report on other information. This includes manner of reporting in different scenarios e.g., other information received prior or after the date of audit report, information received partly prior and partly after the date of audit report, if material mis-statements are identified and not corrected by the management etc.

6. *Management responsibilities for the financial statements*

It is important for the users to know that auditor is not responsible for preparation of financial statements. This paragraph explains that responsibility of preparation of financial statements is of board of directors in case of company and partners in case of partnership firm/LLP. In some entities, the appropriate reference may be to those charged with governance.

If those responsible for preparing financial statements are different than those responsible for the oversight of the financial reporting process, then auditor's report shall also identify those responsible for the oversight of the financial reporting process e.g., in case of consolidated financial statements, holding company's management will be responsible for preparing consolidated financial statements and board of directors of respective companies included in the group and of associates or joint venture are responsible for overseeing the financial reporting process

7. *Auditor's Responsibilities for the Audit of the Financial Statements*

With an objective to bring about more clarity as regards auditor's role and responsibility the standard has expanded the standard paragraph on auditor's responsibility. This includes more clarity about auditor's responsibility with respect to

- o Fraud
- o Internal financial control
- o Going concern
- o Communication with respect to key audit matters
- o Accounting policies and accounting estimates
- o Evaluating the overall presentation, description of materiality, structure and content of the financial statements and disclosures, group audits, and communications with those charged with governance.

It is important to note that expansion in this para does not mean that auditor's responsibilities have increased. It is only

elaboration of responsibilities which are otherwise also existing.

Since length of auditor's responsibility section has increased, SA 700(revised) provides that certain parts of the description may be presented in an appendix to the auditor's report. Where law, regulation or applicable auditing standards expressly permit then the reference of website of an appropriate authority can also be given. Presently, under Companies Act, 2013, there is no reference of appropriate authority. Therefore, auditor should include it either in the body of the auditor's report or give it as an annexure.

In case of non-corporate entities or companies where reporting on internal financial control is not applicable suitable modification should be done to the formats provided in the illustrative audit reports.

There is now a requirement to be mention about the materiality considered while performing the audit. The implementation guide/the illustration has provided standard paragraph which can be included in the auditor's report. There is no requirement to provide amount of materiality which is considered for the purpose of execution of audit. In many jurisdictions across the world who have adopted ISA 700 (revised), there are instances where the amount of materiality has been included in the auditor's report.

8. *Other reporting responsibility*

In this paragraph, the auditor is required to report on specific reporting requirements as required by the relevant law. For example reporting requirement under Companies Act, 2013.

9. Signature & place of the Auditor

Auditor can sign the audit report at a place other than the city where the registered office of the entity is situated. Directors and auditor need not sign the financial statements at the same location. Auditor should mention the location where he signs the audit report.

10. Date of auditor’s report

It cannot be prior to management has asserted that they have taken the responsibility for the financial statement. E.g., in case of company, it is the date when board of directors approves the financial statements. It is possible that it is dated after the date of the board meeting in which the financial statements are approved.

D. Reporting requirement in specific circumstances

<i>Particulars</i>	<i>Guidance</i>
When law or regulation prescribes format different than SA 700 (revised)	<ul style="list-style-type: none"> To the extent allowed, auditor should change the prescribed format to bring in line with the SA e.g., add responsibility paragraph if it is not there.
	<ul style="list-style-type: none"> In case of Form 3CB (tax audit report) there is no option to change the format and layout. The paragraphs relating to auditor responsibility and management responsibility should be added in the observations and comments section to ensure compliance with SA 700 (revised).
	<ul style="list-style-type: none"> Different layout would be acceptable as long as basic elements prescribed in para 49 of SA 700 (revised) are given in the audit report e.g., title, management responsibility, auditor’s responsibility, etc.
	<ul style="list-style-type: none"> If it is not possible to change the format and it is not possible to incorporate the requirements of the SA 700 (revised) then in such cases, auditor may consider Emphasis of Matter or give Modified opinion.
When a statute or court order or government directive/ permission allows an entity to prepare financial statements without meeting a GAAP requirement	<ul style="list-style-type: none"> An entity may be permitted to account for a certain type of income or expenditure on cash basis which is not permitted by the Accounting Standards.
	<ul style="list-style-type: none"> This is not a non-compliance with the framework but compliance with a modified framework.
	<ul style="list-style-type: none"> If the effect is material, the auditor should describe the resultant deviation from the framework in sufficient detail in an Emphasis of Matter paragraph.

<i>Particulars</i>	<i>Guidance</i>
When supplementary information presented with the financial statements or where law or regulation requires additional information that is outside the scope of the applicable financial reporting framework	<ul style="list-style-type: none"> As far as possible, suggest auditee to give such information separately from financial statements e.g., Director's report.
	<ul style="list-style-type: none"> In normal circumstances, auditor will have to audit this information and report on it, if it is part of financial statement.
	<ul style="list-style-type: none"> If the management doesn't want it to be audited, mention that it is unaudited.
	<ul style="list-style-type: none"> In the above instance, auditor will still have reporting responsibilities under SA 720 (revised).

Standard on Auditing (SA) 720 (Revised)- The auditor's responsibilities relating to other information

A. Overview and applicability

From the perspective of the reader of the annual report, it is expected that there is consistency in the information given in the financial statements and other information included in the annual report.

There could also be instances where information given in the director's report may affect the auditor's opinion on the audited financial statements e.g., management may have given additional information in the director's report as regards certain litigation which are going on whereas auditor may not be aware of or had limited information based on which he would have concluded his verification. In some cases, it is possible that management has disclosed certain financial/non-financial information which is not consistent with the audited financial statements.

The evidence or knowledge obtained during the audit will be very important to correlate and verify other information. It should be noted that the auditor's responsibilities under this SA do not constitute an assurance engagement on

other information or impose an obligation on the auditor to obtain assurance about the other information.

SA 720 (revised) deals with auditor's responsibilities and guidance on reporting relating to other information (financial or non-financial) included in entity's annual report. As per the existing SA 720, auditor was required to verify other information included in the annual report like board of directors report etc., however there was no specific requirement to report.

This SA is effective for audits of financial statements for periods beginning on or after 1st April, 2018. The reporting requirements in SA 720 (revised) is not applicable in case of non-corporate entities (partnership firm/LLP/individual/trust).

B. What is other information

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

In case of listed companies

- Board of directors report including its annexures
- Management discussion and analysis
- Corporate governance report

In case of unlisted companies

Board of director's report including its annexures.

As stated above, it includes both financial and non-financial information. Some of the examples are given below:

Examples of other information — where amounts are involved

- Items in a summary of key financial results, such as net income, earnings per share, dividends, sales and other operating revenues, and purchases and operating expenses
- Liquidity and capital resource information, such as cash, cash equivalents and marketable securities; dividends; and debt, capital lease and minority interest obligations
- Financial measures or ratios, such as gross margin, return on average capital employed, return on average shareholders' equity, current ratio, interest coverage ratio and debt ratio. Some of these may be directly reconcilable to the financial statements
- Amounts involved in, and related financial effects of, off-balance sheet arrangements

Examples of other information — where amounts are not involved

- Descriptions of guarantees, contractual obligations, litigation or environmental liability cases, and other contingencies
- Descriptions of changes in legal or regulatory requirements, have a material impact on the entity's financials

- Descriptions of trends in market prices of key commodities or raw materials
- Explanations of specific factors influencing the entity's profitability in specific segments

C. What is not included

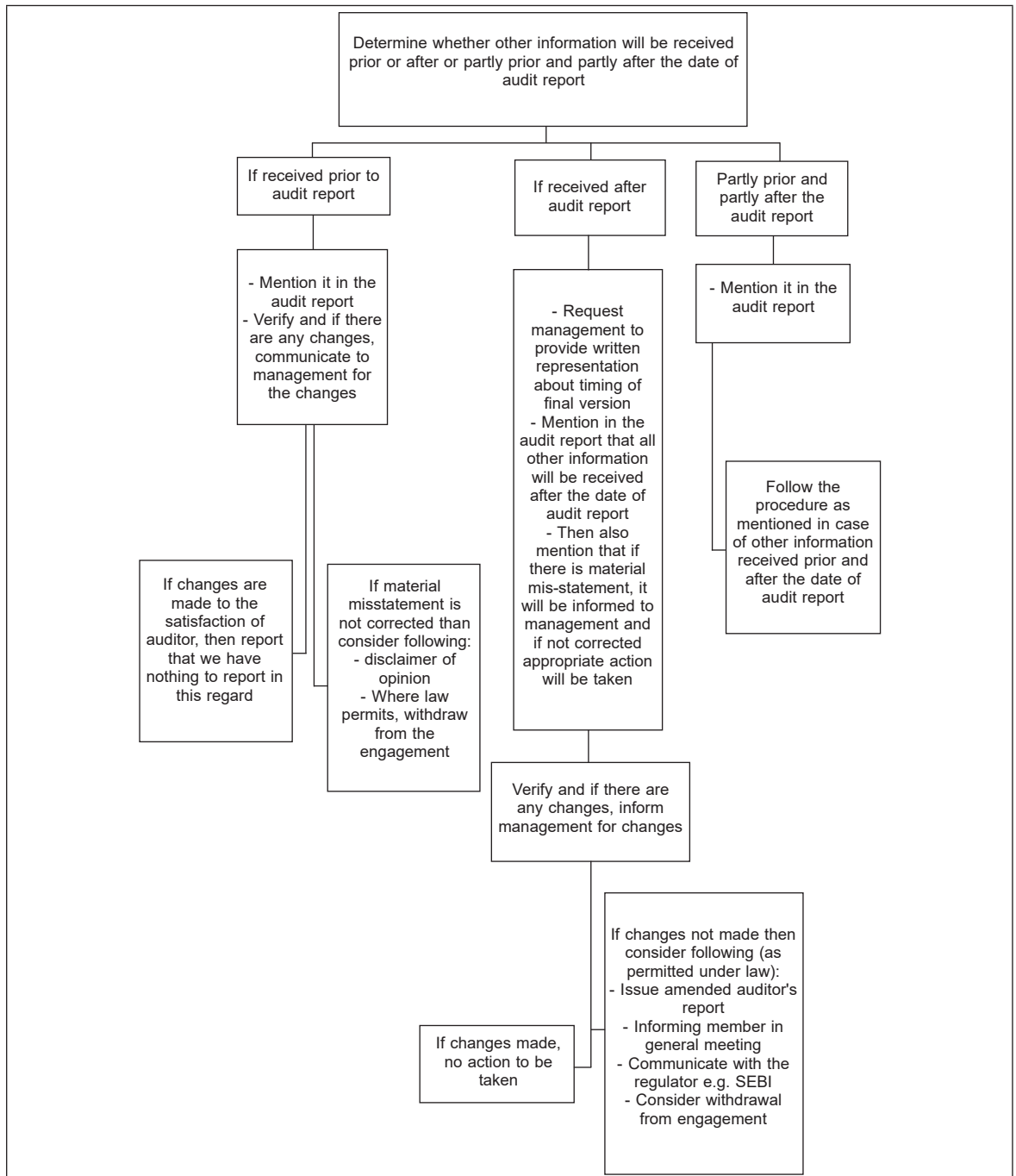
Examples of reports that, when issued as standalone documents, are not typically part of the combination of documents that comprise an annual report (subject to law, regulation or custom), and that, therefore, are not other information within the scope of this SA, include:

- Separate industry or regulatory reports (for example, capital adequacy reports), such as may be prepared in the banking, insurance, and pension industries
- Corporate social responsibility reports
- Sustainability reports
- Diversity and equal opportunity reports
- Product responsibility reports
- Labour practices and working conditions reports
- Human rights reports
- Other regulatory filings with the Government agencies such as the Registrar of Companies.

Further, other information also does not include:

- Preliminary announcements of financial information
- Securities offering documents, including prospectuses

D. Key elements and audit steps



E. Reporting requirements

The following are the key elements of the reporting requirements in the audit report

- Statement that management is responsible for other information
- Identification of other information including what is obtained prior to the date of audit report and what is expected to be received subsequent to the date of audit report
- Statement that audit opinion does not cover the other information and

hence no opinion is expressed on the same

- Description of auditors responsibility i.e., reading the other information and considering the same as required by this standard
- When information has been received prior to the date of the audit report, an affirmative statement that there is nothing to report on the other information or there is uncorrected material misstatement in the other information.

F. Common reporting issues and guidelines

<i>Particulars</i>	<i>Guidance</i>
When there is a qualification in the auditor’s report	<ul style="list-style-type: none"> • Auditor should verify that how it is communicated in the other information. E.g., qualified opinion on the financial statements because of non-disclosure of directors’ remuneration as required by the applicable financial reporting framework may have no implications for the reporting required under this SA.
In case of private companies, there is no annual report	<ul style="list-style-type: none"> • In case of private companies, there is no requirement under law to issue of annual reports. There is only board of director’s report which is there as other information. Therefore, in case of private companies, auditor has to consider only board of director’s report for the purpose of verification and reporting under this SA.
In case of unlisted non-corporate entities (e.g. partnership firm) what is auditor’s responsibility under this standard	<ul style="list-style-type: none"> • Though there is no reporting requirement, all the other requirements in SA 720 (revised) will be equally applicable to audits of all unlisted entities i.e., auditor’s responsibility as regards verification of other information.

G. Tips for auditors

- Changes required in engagement letter with respect to reporting responsibilities for other information
- At planning stage, auditor should what is the other information and design appropriate audit steps
- Discuss with management, whether other information will be received prior or after the date of audit report
- Time management – since this would be one of last information to be received, care needs to be taken for verification of the same
- Communicating the changes which are required in the other information
- Ensure that the changes are done appropriately by the management
- Auditor should know what options are available if there is material misstatements which are not corrected by the management

- Documentation
 - o Documentation of the procedures performed
 - o The final version of the other information should be kept in the audit file

Concluding remarks

In our view, changes in SA 700 (revised) and 720 (revised) along with changes in other SAs which are related to reporting by the auditor will bring more transparency and increase credibility of the audit report. ICAI's intention behind making these changes is to ensure that reader of the audit report focuses on the aspects relevant to them and at the same time safeguard auditor's responsibility.

Reader will have greater clarity and understanding of the management responsibility and auditor's responsibility, increase the reliability on the other information in view of comprehensive reporting by auditors not only on the financial statements but also on the other information. One fallout which we can highlight is on the length of the audit report. Therefore, it is to be seen in coming days whether objective to bring more clarity and transparency in the audit report is fetching its intended result.

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Upon ages of struggle a character is built. Be not discouraged. One word of truth can never be lost; for ages it may be hidden under rubbish, but it will show itself sooner or later. Truth is indestructible, virtue is indestructible, purity is indestructible.

— Swami Vivekananda