



**FAQs on Important Principles enunciated in Standards on Auditing w.r.t.  
Auditor's Opinion and Audit Sampling**

Standard on Auditing (SA) 700(Revised), "Forming an Opinion and Reporting on Financial Statements" deals with the form and content of audit report. SA 705(Revised), "Modifications to the Opinion in the Independent Auditor's Report" deals with how the form and content of audit report is affected when the auditor expresses a modified opinion. SA 530, "Audit Sampling" prescribes the principles for using audit sampling in audit engagements.

**Some FAQs on important principles enunciated in SA 700(Revised) and SA 705(Revised) w.r.t auditor's opinion and important principles enunciated in SA 530 w.r.t. audit sampling are given below.**

**Question 1: When shall auditor express an unmodified (clean) opinion?**

**Response:**

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

In order to conclude that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework, the auditor needs to reach a conclusion that the financial statements, taken as a whole, are free from material misstatement, whether due to fraud or error. To reach this conclusion, the auditor needs to determine whether:

- (a) Sufficient appropriate audit evidence has been obtained in accordance with SA 330;
- (b) Uncorrected misstatements are, individually or in the aggregate, not material in accordance with SA 450;
- (c) Requirements of the financial reporting framework (e.g., the Accounting Standards) have been materially complied with;
- (d) Management's judgements in preparing the financial statements are free from 'bias' (refer SA 260 (Revised) and SA 540);
- (e) The financial statements adequately disclose the accounting policies selected and applied;
- (f) Those accounting policies are appropriate and consistent with the financial reporting framework;
- (g) The accounting estimates made by management are reasonable;
- (h) The information presented in the financial statements is relevant, reliable,



comparable and understandable;

- (i) There are adequate disclosures in financial statements for the users to understand the effect of material transactions and events on the information conveyed in the financial statements;
- (j) The terminology used in the financial statements and the title of each financial statements is appropriate, and the financial reporting framework is adequately referred to or described;
- (k) In reporting under a fair presentation framework, the financial statements indeed achieve a true and fair presentation, after considering –
  - The overall presentation, structure and content of the financial statements, and that
  - The financial statements, including the related notes, represent the underlying transactions in a manner that is true and fair.

**Question 2: Which circumstances require auditor to express modified opinion?**

**Response:**

The auditor is required to express modified opinion in following two circumstances:

- (a) When the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
- (b) When the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

**Question 3: What are the different types of modified opinions?**

**Response:**

There are three types of modified opinions, (i) a qualified opinion, (ii) an adverse opinion, and (iii) a disclaimer of opinion. The decision regarding which type of modified opinion is appropriate depends upon:

- (a) 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
- (b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

The table below illustrates how the auditor's judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.



| Nature of Matter Giving Rise to the Modification          | Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements |                        |
|-----------------------------------------------------------|-----------------------------------------------------------------------------------------------------------|------------------------|
|                                                           | Material but Not Pervasive                                                                                | Material and Pervasive |
| Financial statements are materially misstated             | Qualified opinion                                                                                         | Adverse opinion        |
| Inability to obtain sufficient appropriate audit evidence | Qualified opinion                                                                                         | Disclaimer of opinion  |

**Question 4: When auditor is required to express a qualified opinion?**

**Response:**

The auditor is required to express a qualified opinion in following two circumstances:

- (a) When 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
- (b) When 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.

**Question 5: When auditor is required to express an adverse opinion?**

**Response:**

The auditor is required to express 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.

**Question 6: When auditor is required to express a disclaimer of opinion?**

**Response:**

The auditor is required to disclaim 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.

Further, the auditor is required to disclaim an opinion **when, in extremely rare circumstances involving multiple uncertainties**, the auditor concludes that,



notwithstanding having obtained sufficient appropriate audit evidence regarding each of 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.

**Question 7: What is a ‘material misstatement’ of financial statements?**

**Response:**

For financial statements to comply with an applicable financial reporting framework, the transactions and events as reflected therein need to comply with four aspects. These are:

- (a) Recognition
- (b) Measurement
- (c) Classification and presentation, and
- (d) Disclosure

A “misstatement” of the financial statements occurs when there is a difference between how each of these aspects is reported by the management in the financial statements and how it should be reported as per the applicable financial reporting framework.

As per SA 450, “Evaluation of Misstatements Identified during the Audit”, material misstatement of the financial statements may arise in relation to:

- (a) The appropriateness of the selected accounting policies;
- (b) The application of the selected accounting policies, or
- (c) The appropriateness or adequacy of disclosures in the financial statements.

**Appropriateness of the Selected Accounting Policies**

In relation to the appropriateness of the accounting policies management has selected, material misstatements of the financial statements may arise when:

- (a) The selected accounting policies are not consistent with the applicable financial reporting framework; or
- (b) The financial statements, including the related notes, do not represent the underlying transactions and events in a manner that achieves fair presentation.

Financial reporting frameworks often contain requirements for the accounting for, and disclosure of, changes in accounting policies. Where the entity has changed its selection of significant accounting policies, a material misstatement of the financial statements may arise when the entity has not complied with these requirements.

**Application of the Selected Accounting Policies**

In relation to the application of the selected accounting policies, material misstatements of the financial statements may arise:



- (a) When management has not applied the selected accounting policies consistently with the financial reporting framework, including when management has not applied the selected accounting policies consistently between periods or to similar transactions and events (consistency in application); or
- (b) Due to the method of application of the selected accounting policies (such as an unintentional error in application).

**Appropriateness or Adequacy of Disclosures in the Financial Statements**

In relation to the appropriateness or adequacy of disclosures in the financial statements, material misstatements of the financial statements may arise when:

- (a) The financial statements do not include all of the disclosures required by the applicable financial reporting framework;
- (b) The disclosures in the financial statements are not presented in accordance with the applicable financial reporting framework; or
- (c) The financial statements do not provide the disclosures necessary to achieve fair presentation.

It is often wrongly believed that a “material misstatement” is only a recognition and measurement issue alone. In other words, there is a perception that one does not need to modify an opinion, unless the rupee amounts are misstated. Due to this perception, auditors may fail to modify their opinion in respect of material misstatement of the financial statements caused by inappropriate classification or presentation, or inadequate disclosure.

**Question 8: When is the effect of a misstatement or a possible misstatement considered to be “pervasive”?**

**Response:**

Both a material misstatement (where evidence is available) and a possible misstatement (where evidence is not available) need to be evaluated for being pervasive or otherwise.

The effect of a material misstatement/possible misstatement is Pervasive, when:

- (a) Where it pertains to an amount(s) in the financial statements, it is not confined to specific components, accounts or items of the financial statements. If it is so confined, it represents or could represent a substantial portion of the financial statements; or
- (b) Where it pertains to disclosures, such disclosures or the matter(s) therein are / could be fundamental to the user’s understanding of the financial statements.

For example, where an auditor detects a bias in the valuation of estimates on the assets side of a balance sheet (such as increasing the useful lives of fixed assets without justification, not treating impairment in investments as other than temporary, treating doubtful receivables as good, not providing adequately for inventory obsolescence, etc.)



all building up to an overstatement of earnings, the aggregate effect of which, may be material to the financial statements taken as a whole, then the possible misstatement is said to be pervasive.

In another example, when the misstatement is only in valuing inventory of a major raw material at cost instead of at net realisable value and when clear evidence is available that the fair value of the material was substantially lower than cost and the selling price of the finished product is pegged to current raw material prices, and the difference in valuation, if booked, could wipe out a substantial portion of the profit before tax of the entity, the misstatement is said to be pervasive.

In yet another example, the entity is unable to resolve to the satisfaction of the auditor, a going concern issue in relation to one of its major subsidiaries, in which the entity has a substantial exposure in terms of equity, debt and guarantee commitments and it refuses to either make a provision or a satisfactory disclosure of the matter, the misstatement is said to be pervasive.

**Question 9: What is the inability of an auditor to obtain sufficient appropriate audit evidence?**

**Response:**

Ordinarily, an auditor would be unable to obtain sufficient appropriate audit evidence **(also referred to as a limitation on the scope of the audit)** in the following situations:

- (a) Circumstances beyond the control of an entity – For example, the entity's accounting records are destroyed by fire or are seized by an investigating agency;
- (b) Circumstances related to the nature and timing of the auditor's work – Examples:
  - (a) for equity accounting of an associate, adequate financial information of the associate is not available;
  - (b) the auditor is appointed after year-end, and is therefore unable to observe physical verification of inventory; or
  - (c) where the controls of the entity are not effective and the auditor concludes that performing substantive procedures alone is not sufficient;
- (c) Limitation imposed by management – For example, management prevents the auditor from observing inventory count or from requesting external confirmation of specific account balances, or imposes unrealistic time deadlines within which to issue an auditor's report.

It is pertinent to note that an inability to perform a specific procedure does not constitute a limitation on the scope of the audit if the auditor is able to obtain sufficient appropriate audit evidence by performing alternative procedures.

**Question 10: If the management imposes a scope limitation after the auditor has accepted the engagement, what should he do?**

**Response:**



As a first step, the auditor should request the management to remove the scope limitation. If the management refuses, he should communicate with those charged with governance and simultaneously explore ways to perform alternative procedures to obtain sufficient appropriate audit evidence.

If the auditor concludes that he is still unable to get sufficient appropriate audit evidence, he should determine if the possible effect of undetected misstatements is likely to be material but not pervasive. If so, he should qualify his opinion.

If he concludes that the possible effect of undetected misstatements is likely to be both material and pervasive and qualification of the opinion alone would not suffice, he should withdraw from the audit, if permitted to do so, by the applicable law or regulation. But where the law or regulation does not permit withdrawal of the auditor for such reason after accepting an audit, he should give a disclaimer of opinion.

**Question 11: What is meant by sampling risk?**

**Response:**

Sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

- (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
- (ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

**Question 12: How should auditor determine sample size?**

**Response:**

The auditor is required to determine a sample size which is sufficient to reduce sampling risk to an acceptably low level.

The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be. The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment.





**Question 13: How should auditor select items for sample?**

**Response:**

The auditor is required to select items for the sample in such a way that each sampling unit in the population has a chance of selection.

In statistical sampling, sample items are selected in a way that each sampling unit has a known probability of being selected. In non-statistical sampling, judgment is used to select sample items. Because the purpose of sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected, it is important that the auditor selects a representative sample, so that bias is avoided, by choosing sample items which have characteristics typical of the population. The principal methods of selecting samples are the use of random selection, systematic selection and haphazard selection.

**Question 14: What is the auditor's responsibility to determine completeness of population from which audit sample is drawn?**

**Response:**

In accordance with the requirement of SA 500, "Audit Evidence" (paragraph 9 of SA 500), when performing audit sampling, the auditor is required to perform audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

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