

Certified Public Accountants

accounting alert

2006-04: December 14, 2006

New Wording for the Independent Auditor's Report

In a capsule...

- A new wording for the independent auditor's report with unqualified opinion has been approved by the Auditing and Assurance Standards Council (AASC) and by the Board of Accountancy and Professional Regulation Commission for implementation in the Philippines. The Securities and Exchange Commission has adopted as part of its rules and regulations the use of such new wording for the auditor's report.
- The new wording is required for auditor's reports dated on or after December 31, 2006. This means that auditor's reports on financial statements for the year ending December 31, 2006 will use the new auditor's report wording.
- The independent auditor's report with unqualified opinion now includes five paragraphs (assuming the auditor has no other reporting responsibilities for other matters, such as supplementary schedules) versus the three paragraphs used in the current auditor's report that will be replaced.
- The wording for the modified reports (i.e., reports with qualified opinion, adverse opinion, disclaimer of opinion and emphasis of matters) are also being revised to conform the wording of such modified reports with the new wording for reports with unqualified opinion.
- The changes made in the new report wording are of great importance both to independent auditors who report on the financial statements and to management of companies whose financial statements are being reported on. The distinct responsibilities of independent auditors and management over audited financial statements are better explained in the new report wording.

- A sample independent auditor's report with an unqualified opinion using the new wording is shown below.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 2006, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Philippine Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Philippine Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of ABC Company as of December 31, 2006, and of its financial performance and its cash flows for the year then ended in accordance with Philippine Financial Reporting Standards.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Introduction

In February 2006, the Auditing and Assurance Standards Council (AASC) approved for adoption in the Philippines the Philippine Standard on Auditing (PSA) 700 (Revised), *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*. PSA 700 (Revised) was approved by the Board of Accountancy and the Professional Regulation Commission in June 2006 and was adopted by the Securities and Exchange Commission as part of its rules and regulations through the SEC Memorandum Circular No. 12, Series of 2006 issued on October 30, 2006.

PSA 700 (Revised) introduced a number of important changes to the auditing standard covering independent auditor's report that contain unqualified opinion, the most significant of which is the new wording for the auditor's report. PSA 700 (Revised) is effective for auditor's reports dated on or after December 31, 2006. This means that auditor's reports on financial statements for the year ending December 31, 2006 will use the new auditor's report wording.

The changes introduced in PSA 700 (Revised) are of great importance not only to independent auditors who report on financial statements audited by them but also to management of companies whose financial statements are being reported on. This is because the new auditor's report wording includes, among others, a better explanation of the responsibilities of management for the financial statements. For this reason, it will be important that management also have an appreciation of the changes made to the wording for the auditor's report that will accompany their audited financial statements.

As part of the issuance of PSA 700 (Revised), the standards and guidance in the previous PSA 700 relating to modified reports were relocated to a new PSA 701 which included revisions to conform the wording for the modified reports to the new wording for unqualified reports. PSA 701 is currently being revised under AASC Exposure Draft No. 75 that proposes the issuance of two new PSAs (based on the exposure draft issued by the International Auditing and Assurance Standards Board, or IAASB).

The proposed new PSAs covering auditor's reports that contain other than unqualified opinion are the following:

- Proposed PSA 705, *Modifications to the Opinion in the Independent Auditor's Report*, and
- Proposed PSA 706, *Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report*

While the IAASB is yet to issue the final auditing pronouncements corresponding to the above proposed standards, we believe that the guidance presented in the exposure draft may already be applied in situations where the auditor is contemplating to issue auditor's reports that contain other than unqualified opinion. Accordingly, the examples of auditor's reports containing modified opinion and emphasis of matter paragraphs or other matters paragraphs presented in the Attachment to this Accounting Alert may already be used considering the specific circumstances described for each example.

This Accounting Alert discusses the applicability of the new wording for the auditor's report under PSA 700 (Revised), presents the elements of the auditor's report and gives examples of auditor's report that contain unqualified opinion under PSA 700 (Revised), modified opinion under proposed PSA 705, or emphasis of matter paragraphs or other matters paragraphs under proposed PSA 706.

Applicability of the New Wording for the Auditor's Report under PSA 700 (Revised)

The new wording for the auditor's report under PSA 700 (Revised) applies to independent auditor's report issued as a result of an audit of a complete set of general purpose financial statements prepared in accordance with a financial reporting framework that is designed to achieve fair presentation. PSA 700 (Revised) only addresses circumstances when the auditor is able to express an unqualified opinion and no modification to the report is necessary.

Accordingly, the new wording under PSA 700 (Revised) applies only to an auditor's report issued in connection with the:

- a. **Audit of a complete set of general purpose financial statements, i.e., those designed to meet the common information needs of a wide range of users.** A complete set of financial statements under Philippine Financial Reporting Standards (PFRS) comprises of:
 - a balance sheet,
 - an income statement,
 - a statement of changes in equity,
 - a cash flow statement, and
 - a summary of significant accounting policies and other explanatory notes.

- b. **Audit of financial statements which are prepared in accordance with a financial reporting framework that is designed to achieve fair presentation.** PFRS is an example of a financial reporting framework. PAS 1, *Presentation of Financial Statements*, indicates that the application of PFRS, with additional disclosure when necessary, is presumed to result in financial statements that achieve fair presentation. Part of the auditor's responsibility is to determine whether the financial reporting framework adopted by management in preparing the financial statements is acceptable.
- c. **Audit of financial statements on which the auditor is issuing an unqualified opinion and no modification is necessary.** The new wording under PSA 700 (Revised) applies only to auditor's report that contains an unqualified opinion. Another auditing standard, PSA 701, *Modifications to the Independent Auditor's Report*, applies when there are modifications to the auditor's report for an emphasis of a matter, a qualified opinion, a disclaimer of opinion, or an adverse opinion (see later section of this Accounting Alert).

For special engagements (such as, complete set of financial statements prepared in accordance with another comprehensive basis of accounting, a single financial statement or specified accounts/items, and summarized financial statements), PSA 800, *The Independent Auditor's Report on Special Purpose Audit Engagements*, shall be applied.

Elements of the Auditor's Report

PSA 700 (Revised) prescribed that the auditor's report on an audit that has been conducted in accordance with the PSAs should have the following elements which are briefly described below.

- a. **Title.** The auditor's report should have a title and such title should clearly indicate that it is the report of an independent auditor. For example, the title "Independent Auditor's Report" is acceptable as it affirms that the auditor has met all the relevant ethical requirements regarding independence and, therefore, distinguishes the independent auditor's report from reports issued by others.
- b. **Addressee.** The auditor's report should be addressed as required by the circumstances of the engagement. Ordinarily, the auditor's report on general purpose financial statements is addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements have been audited.

- c. **Introductory paragraph.** The introductory paragraph in the auditor's report should:
- identify the entity whose financial statements have been audited,
 - state that the financial statements have been audited,
 - identify the title of each of the financial statements that comprise the complete set of financial statements,
 - refer to the summary of significant accounting policies and other explanatory notes, and
 - specify the date and period covered by the financial statements.

In addition, when the auditor is aware that the financial statements will be included in a document that contains other information, such as an annual report, the auditor may identify the page numbers on which the financial statements are presented. This helps readers to identify the financial statements to which the auditor's report relates.

In some circumstances, the entity may be required by law or regulation or standards, or may voluntarily choose, to present together with the financial statements supplementary information that is not required by the financial reporting framework.

For example, supplementary information might be presented to enhance a user's understanding of the financial reporting framework or to provide further explanation of specific financial statement items. Such information is normally presented in either supplementary schedules or as additional notes. The auditor's opinion may or may not cover the supplementary information and it is therefore important for the auditor to be satisfied that any supplementary information that is not covered by the auditor's opinion is clearly differentiated, such as by clearly labeling the information as "unaudited," or placing the unaudited information outside of the set of the financial statements.

d. **Management's responsibility for the financial statements.** Financial statements are the representation of management. The auditor's report should state that management is responsible for the preparation and the fair presentation of the financial statements in accordance with the applicable financial reporting framework. This responsibility includes:

- designing, implementing and maintaining internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error;
- selecting and applying appropriate accounting policies; and
- making accounting estimates that are reasonable in the circumstances.

For example, in the case of financial statements prepared in accordance with PFRS, management is responsible for preparing financial statements that fairly present the financial position, financial performance (results of operations) and cash flows of the entity in accordance with PFRS. To fulfill this responsibility, management designs and implements internal control to prevent or to detect and correct misstatements, whether due to fraud or error, in order to ensure the reliability of the entity's financial reporting. The preparation of the financial statements requires management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies.

e. **Auditor's responsibility.** The auditor's report should:

- state that the responsibility of the auditor is to express an opinion on the financial statements based on an audit (in order to contrast it to the management's responsibility for the preparation and fair presentation of the financial statements);
- state that the audit was conducted in accordance with Philippine Standards on Auditing (i.e., the auditor has complied with all of the PSAs relevant to the audit, as well as with ethical requirements);
- describe an audit as involving performing procedures to obtain audit evidence and the procedures are selected depending on the auditor's judgment, including assessment of the risks of material misstatement of the financial statements; and
- state that the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

- f. **Auditor's opinion.** An unqualified opinion should be expressed when the auditor concludes that the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. For example, in the case of financial statements prepared in accordance with PFRS, the auditor expresses an opinion that the financial statements present fairly, in all material respects, the financial position of the entity as at the end of the period and its financial performance (results of operations) and cash flows for the period then ended.

Appropriate reference should be made to the financial reporting framework in the wording of the auditor's opinion (such as, "in accordance with Philippine Financial Reporting Standards" when PFRS is used as the financial reporting framework). When PFRS, or IFRS are not used as the financial reporting framework, the reference to the financial reporting framework in the wording of the auditor's opinion should identify the jurisdiction or country of origin of the financial reporting framework (such as, "in accordance with accounting principles generally accepted in Country X").

- g. **Other reporting responsibilities.** The auditor may have additional responsibilities to report on other matters that are supplementary to the auditor's responsibility to express an opinion on the financial statements. For example, the auditor may be asked to report certain matters if they come to the auditor's attention during the course of the audit of the financial statements. Or the auditor may be asked to perform and report on additional specified procedures, or to express an opinion on specific matters, such as the adequacy of accounting books and records.

When the auditor addresses other reporting responsibilities within the auditor's report, he should address these other reporting responsibilities in a separate section of the report in order to clearly distinguish them from the auditor's responsibilities for, and opinion on, the financial statements.

- h. **Auditor's signature.** The auditor's report should be signed.

In the Philippines, SRC Rule 68 of the SEC requires that the auditor's report on financial statements filed with the SEC, which will likewise be filed with the Bureau of Internal Revenue (BIR), be manually signed. In case of an auditing firm, the certifying partner shall sign his/her own signature and shall indicate that he/she is signing for the firm, the name of which is also indicated in the report. The auditor is also required to state the signing accountant's license, Tax Identification No., Privilege Tax Receipt No., registration number with the Professional Regulation Commission/Board of Accountancy, and accreditation issued by the SEC for audits of public companies and secondary licensees and by the BIR.

- i. **Date of the auditor's report.** The auditor should date the report on the financial statements no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements. Sufficient appropriate audit evidence should include evidence that the entity's complete set of financial statements has been prepared and that those with the recognized authority have asserted that they have taken responsibility for them.

Following are additional guidance in dating the auditor's report:

- The auditor should consider the effect of events and transactions of which the auditor became aware and that occurred up to the date of the auditor's report.
 - Since the auditor's opinion is provided on the financial statements and the financial statements are the responsibility of management, the auditor can conclude that sufficient appropriate audit evidence has been obtained only when the auditor obtains evidence that a complete set of financial statements has been prepared and management has accepted responsibility for them. Hence, the auditor should obtain evidence of that approval from the company's management before dating the report on the financial statements.
 - In certain cases, final approval of the financial statements by shareholders may be required before the financial statements are issued publicly. In such cases, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence has been obtained. The date of approval of the financial statements for purposes of the PSAs is the earlier date on which those with the recognized authority determine that a complete set of financial statements has been prepared.
- j. **Auditor's address.** The auditor's report should include the name of the location in the country where the auditor practices.

Example of a New Auditor's Report with Unqualified Opinion

PSA 700 (Revised) requires that the auditor's report should be in writing. A written report encompasses both reports issued in hard copy format and in electronic/soft copy format.

The following sample report is an illustration of the auditor's report incorporating the elements discussed above for an audit of financial statements prepared in accordance with PFRS expressing an unqualified opinion. (Please see later section of this Accounting Alert for examples of auditor's report with other than unqualified opinion.)

This new wording will replace the three-paragraph unqualified report being used currently.

This sample assumes that the entity whose financial statements are being reported on is a listed company, hence, in addition to the audit of the financial statements, the auditor has other reporting responsibilities to issue a separate auditor's opinion on supplementary schedules required to be submitted by the entity to the SEC.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 2006, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Philippine Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Philippine Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of ABC Company as of December 31, 2006, and of its financial performance and its cash flows for the year then ended in accordance with Philippine Financial Reporting Standards.

Report on Other Legal and Regulatory Requirements

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The applicable supplementary Schedules A to I (see table of contents) of the Company as at December 31, 2006 and for the year then ended, required by the Securities and Exchange Commission, are presented for purposes of additional analysis and are not a required part of the basic financial statements. The information in such supplementary schedules has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Auditor’s Reports with Modification and Emphasis of Matter Paragraph or Other Matters Paragraphs

As mentioned in the Introduction to this Accounting Alert, as part of the issuance of PSA 700 (Revised), the standards and guidance in the previous PSA 700 on modified reports, which were relocated to a new PSA 701, are currently under revision to align them to the new guidance and wording for auditor’s report under PSA 700 (Revised).

Auditor’s Reports with Modifications to the Opinion under Proposed PSA 705

The **proposed PSA 705** requires the auditor to modify his opinion in the auditor’s report in the following circumstances:

- The auditor concludes that, based on the audit evidence obtained, the financial statements are not free from material misstatement and, accordingly, are not prepared, in all material respects, in accordance with an applicable financial reporting framework. Disagreements with management may relate to:
 - i. the acceptability of selected accounting policies,
 - ii. the application of the selected accounting policies, or
 - iii. the adequacy of disclosures in the financial statements.
- The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements are free from material misstatement (also referred to as a limitation on the scope of the audit).

Types of modified opinions – **Proposed PSA 705** establishes three types of modified opinions, e.g., a qualified opinion, an adverse opinion and a disclaimer of opinion. The type of opinion will depend upon the auditor’s judgment about the materiality and pervasiveness of the matter giving rise to the modification to the opinion.

Additional elements of auditor’s report with modified opinion – In addition to the specific elements required to be included in the auditor’s report when the auditor’s opinion is unmodified, the following additional elements should be included in the auditor’s report with modified opinion:

- Basis for modification paragraph that precedes the opinion paragraph and with appropriate heading (such as, “Basis for Qualified Opinion,” “Basis for Adverse Opinion,” or “Basis for Disclaimer of Opinion”). Such paragraph should include:
 - i. a clear description of all the substantive reasons for the modification,

- ii. in the event of a disagreement with management about disclosures, a description of the omitted disclosures, unless impracticable or prohibited by law or regulation,
 - iii. in the event of a disagreement with management, a description and quantification of the principal effects on the financial statements of the matter giving rise to the modification, unless impracticable (if the principal effects are not reasonably quantifiable, the auditor's report should so state), and
 - iv. in the event of an inability to obtain sufficient appropriate audit evidence, a description of the reason for such inability.
- Opinion paragraph that uses an appropriate modifying phrase, such as “except for the effect of the matter described in the Basis for Qualified Opinion paragraph,” “except for the possible effect of the matter described in the Basis for Qualified Opinion paragraph,” “because of the significance of the matters described in the Basis for Adverse Opinion paragraph,” or “because of the significance of the matters described in the Basis of Disclaimer of Opinion paragraph.”
 - In the event of inability to obtain sufficient appropriate audit evidence (or scope limitation), an amended description of the auditor's responsibility (i.e., in the case of a qualified opinion, the auditor's responsibility should state that “except for the matter described in the Basis for Qualified Opinion paragraph, the auditor conducted the audit in accordance with PSAs,” or in the case of a disclaimer of opinion, it should state that “because of the matters described in the Basis for Disclaimer of Opinion paragraph, the auditor was not able to complete an audit in accordance with PSAs”).

Examples of auditor's reports with modifications to the opinion, taken from AASC ED No. 75, are presented in the Attachment to this Accounting Alert.

Auditor's Reports that Include Emphasis of Matter Paragraphs or Other Matters Paragraphs under Proposed PSA 706

Inclusion of emphasis of matter paragraph – The **proposed PSA 706** requires the auditor to emphasize in the auditor's report a matter in the financial statements when, in the auditor's judgment, both of the following conditions are met:

- The matter is of fundamental importance to the user's understanding of the financial statements (i.e., the consequences or possible consequences of the matter could significantly affect the entity's financial position, financial performance (or results of operations) or cash flows), and

- The matter is unusual (i.e., it occurs infrequently or is out of the ordinary course of business for the entity or for other entities in the industry).

An example of a matter to be covered in the emphasis of a matter paragraph is the existence of a material uncertainty regarding an entity's ability to continue as a going concern. Other circumstances include the following:

- Significant uncertainties such as relating to the future outcome of a major litigation or regulatory action,
- Significant and unusual related party transactions,
- Early application of a new accounting principle,
- A subsequent event disclosed in the financial statements, and
- A matter such as a major catastrophe disclosed in the financial statements.

The inclusion of an emphasis of a matter paragraph in the auditor's report does not affect the auditor's opinion. It is not a substitute for either the auditor's expression of a qualified opinion, an adverse opinion, or a disclaimer of opinion when required by the circumstances of a specific audit engagement, or disclosures in the financial statements that management is required to make.

An emphasis of matter paragraph should follow the opinion paragraph in the auditor's report and should have an appropriate heading, such as "Emphasis of Matter," that clearly describes the matter being emphasized. The auditor draws attention to the disclosure in the financial statements that discusses the matter. He should not make disclosures in the emphasis of matter paragraph beyond those included in the financial statements because doing so may imply that there is inadequate disclosure in the financial statements which represents disagreement with management that will give rise to a modification to the auditor's opinion.

Inclusion of other matters paragraph – In some cases, the auditor may find it necessary to communicate information to readers of the report relating to matters other than those that are required to be presented or disclosed in the financial statements. In such cases, the auditor should include such information in a separate paragraph with appropriate heading, such as "Other Matters," that follows the auditor's opinion and any emphasis of matter paragraph.

The other matters paragraph should address only matters that are not recognized or disclosed in the financial statements. Examples are the following:

- Description of a misleading information (or material inconsistency) in a document containing audited financial statements (such as an annual report) that management refuses to amend. Through the other matters paragraph, the auditor can disassociate himself from the misleading information or material inconsistency.
- Matters that provide further explanation of the auditor's responsibilities in the audit of financial statements.
- In rare and unusual circumstances, other matters that the auditor considers relevant to communicate to the user of the financial statements.

Examples of auditor's reports that include emphasis of matters paragraphs or other matters paragraphs, taken from AASC ED No. 75, are presented in the Attachment to this Accounting Alert.

Conclusion

The changes to the wording for the auditor's reports, both for those with unqualified opinion and those with modified opinions, are very important. The responsibilities of management and of auditors over audited financial statements are better explained and distinguished. The description of the audit process is updated and the scope of the auditor's responsibilities with respect to internal control is further clarified.

In making the changes and improvements to the auditor's reports, the standard-setters aim to enhance users' understanding of the auditor's role and of the auditor's report. Audit practitioners should therefore endeavor to always comply with the new standards on reporting, management should take fully their responsibilities over their financial statements and users of auditor's reports in general should be knowledgeable about the meanings and implications of the wording used in the auditor's reports.

Disclaimer

This Accounting Alert is not a comprehensive analysis of the subject matters covered and is not intended to provide accounting, auditing or tax advice to specific entity. All relevant facts and circumstances, including the full text of the pertinent final or proposed standards, rules and regulations and other literature, need to be considered to arrive at accounting, auditing and tax decisions that relate to matters addressed in this Accounting Alert.

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Should you have any questions or should you need assistance on matters covered in this Accounting Alert, please contact the P&A engagement partner assigned to your company, or send an email to any of the following partners of the Firm:

Greg S. Navarro, Managing Partner & CEO, at Greg.S.Navarro@pna.ph

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**Examples of Auditor’s Reports
With Modification and Emphasis of Matters Paragraphs**

(Taken from the sample auditor’s reports presented in AASC ED No. 75)

Example No.	Description
1	Auditor’s report with a qualified opinion due to disagreement with management related to overstatement of inventories (with material but not pervasive effect)
2	Auditor’s report with an adverse opinion due to disagreement with management related to the going concern assumption (with material and pervasive effect)
3	Auditor’s report with an adverse opinion due to disagreement with management related the write-down of accounts receivable (with material and pervasive effect)
4	Auditor’s report with a qualified opinion due to the auditor’s inability to obtain sufficient appropriate audit evidence regarding an investment in a foreign affiliate (with possible material effect but not pervasive)
5	Auditor’s report with a qualified opinion due to the auditor’s inability to obtain sufficient appropriate audit evidence regarding cash sales (with possible material effect but not pervasive)
6	Auditor’s report with a disclaimer of opinion due to the auditor’s inability to obtain sufficient appropriate audit evidence with respect to inventory and accounts receivable (with possible material and pervasive effect)
7	Auditor’s report with a disclaimer of opinion due to the auditor’s inability to obtain sufficient appropriate audit evidence with respect to completeness of accounting records (with possible material and pervasive effect)
8	Auditor’s report with an unmodified opinion and contains an emphasis of matter paragraph referring to a significant uncertainty related to pending litigation and an other matters paragraph referring to a material inconsistency with other information in the annual report containing audited financial statements
9	Auditor’s report with an unmodified opinion and contains an emphasis of a matter paragraph referring to a significant and unusual related party transaction
10	Auditor’s report with an unmodified opinion and contains an emphasis of a matter paragraph referring to uncertainty regarding the effects of a major catastrophe

Example Report 1

Auditor's report with a qualified opinion due to a disagreement with management – overstatement of inventories; the effect of this disagreement with management is deemed to be material but not pervasive to the financial statements. The report also contains an emphasis of matter paragraph.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and the fair presentation of these financial statements in accordance with Philippine Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Philippine Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Basis for Qualified Opinion

The company's inventories are recognized in the balance sheet at P16 million. Based on the audit evidence obtained, we believe that an adjustment to inventories of P5 million is required to recognize slow-moving items at their net realizable value. The tax effect of this adjustment is P1.5 million. Accordingly, we believe that shareholders' equity and profit for the year are both overstated by P3.5 million.

Qualified Opinion

In our opinion, except for the effects of the matters described in the Basis for Qualified Opinion paragraph, the financial statements present fairly, in all material respects the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Philippine Financial Reporting Standards.

Emphasis of Matter

We draw attention to a significant and unusual related party transaction disclosed in Note 10 to the financial statements, which includes an appropriate description of the company's sale of the office equipment division to a member of the company's management team for P100 million.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Example Report 2

Auditor's report with an adverse opinion due to a disagreement with management related to the going concern assumption; the effect of the disagreement with management is deemed to be material and pervasive to the financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements

We have audited ... *(remaining words are the same as illustrated in the introductory paragraph – see Example Report 1 above).*

Management's Responsibility for the Financial Statements

Management is responsible for ... *(remaining words are the same as illustrated in the management's responsibility paragraph – see Example Report 1 above).*

Auditor's Responsibility

Our responsibility is ... *(remaining words are the same as illustrated in the paragraphs describing the auditor's responsibility – see Example Report 1).*

Basis for Adverse Opinion

As discussed in Note X to the financial statements, ABC Company's financing arrangements expired and the amount outstanding was payable on December 31, 20X1. The company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. Based on the audit evidence obtained, we believe that the company will not be able to meet its obligations in the ordinary course of business. Accordingly, we do not agree with management's preparation and presentation of the financial statements on a going concern basis. Had the financial statements been prepared on a liquidation basis of accounting, we

believe that it would have had a significant negative effect on the company's financial position and financial performance.

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the financial statements do not present fairly, in all material respects the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Philippine Financial Reporting Standards.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Example Report 3

Auditor's report with an adverse opinion due to a disagreement with management related to the write-down of accounts receivable in the amount of P5 million; the balance sheet total is P7 million and the profit after tax is P0.3 million. The effect of this disagreement with management is deemed to be both material and pervasive to the financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements

We have audited ... *(remaining words are the same as illustrated in the introductory paragraph – see Example Report 1 above).*

Management's Responsibility for the Financial Statements

Management is responsible for ... *(remaining words are the same as illustrated in the management's responsibility paragraph – see Example Report 1 above).*

Auditor's Responsibility

Our responsibility is ... (*remaining words are the same as illustrated in the paragraphs describing the auditor's responsibility – see Example Report 1*).

Basis for Adverse Opinion

The company's accounts receivable are recognized in the balance sheet at P6 million. Based on the audit evidence obtained, we believe an adjustment to accounts receivable of P5 million is required to recognize a receivable from XYZ Company that cannot be collected. The tax effect is P1.5 million. Accordingly, we believe that shareholders' equity and profit for the year are both overstated by P3.5 million.

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the financial statements do not present fairly, in all material respects the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Philippine Financial Reporting Standards.

Report on Other Legal and Regulatory Requirements

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.*]

[*Auditor's signature*]

[*Date of the auditor's report*]

[*Auditor's address*]

Example Report 4

Auditor's report with a qualified opinion due to the auditor's inability to obtain sufficient appropriate audit evidence regarding an investment in a foreign affiliate; the possible effect of the inability to obtain sufficient appropriate audit evidence can be clearly described in the auditor's report and, while material, is not deemed to be pervasive to the financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements

We have audited ... *(remaining words are the same as illustrated in the introductory paragraph – see Example Report 1 above).*

Management's Responsibility for the Financial Statements

Management is responsible for ... *(remaining words are the same as illustrated in the management's responsibility paragraph – see Example Report 1 above).*

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. Except for the matter described in the Basis for Qualified Opinion paragraph, we conducted our audit ... *(remaining words of the first two paragraphs are the same as in the first two paragraphs of the auditor's responsibility – see Example Report 1 above).*

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

Basis for Qualified Opinion

ABC Company's investment in XYZ Company, a foreign associate accounted for by the equity method, is recognized at P15 million on the balance sheet as at December 31, 20X1, and ABC's share of profit of XYZ Company is recognized at P1 million in the income statement for the year ended December 31, 20X1. We were unable to obtain sufficient appropriate audit evidence in relation to the financial information of XYZ Company because we were unable to obtain access to the accounting records, management, or auditor of XYZ Company.

Qualified Opinion

In our opinion, except for the possible effects of the matters described in the Basis for Qualified Opinion paragraph, the financial statements present fairly, in all material respects the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Philippine Financial Reporting Standards.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Example Report 5

Auditor's report with a qualified opinion due to the auditor's inability to obtain sufficient appropriate audit evidence; the possible effect of the inability to obtain sufficient appropriate audit evidence can be clearly described in the auditor's report and, while material, is not deemed to be pervasive to the financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements

We have audited ... *(remaining words are the same as illustrated in the introductory paragraph – see Example Report 1 above).*

Management's Responsibility for the Financial Statements

Management is responsible for ... *(remaining words are the same as illustrated in the management's responsibility paragraph – see Example Report 1 above).*

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. Except for the matter described in the Basis for Qualified Opinion paragraph, we conducted our audit ... *(remaining words of the first two paragraphs are the same as in the first two paragraphs of the auditor's responsibility – see Example Report 1 above)*

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

Basis for Qualified Opinion

The company's accounting records for cash sales were not adequate for purposes of our audit and therefore there were no satisfactory audit procedures that we could perform to obtain reasonable assurance that all cash sales have been properly recorded. The company's recorded sales, which total P1 million, include P50,000 in cash sales.

Qualified Opinion

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements present fairly, in all material respects the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Philippine Financial Reporting Standards

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Example Report 6

Auditor's report with a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence with respect to inventory and accounts receivable; the auditor was unable to obtain sufficient appropriate audit evidence because management restricted the scope of the auditor's procedures; the report also identifies a disagreement with management related to interest-bearing borrowings; the possible effect of the inability to obtain sufficient appropriate audit evidence is deemed to be material and pervasive to the financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements

We were engaged to audit the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for ... *(remaining words are the same as illustrated in the management's responsibility paragraph – see Example Report 1 above).*

Auditor's Responsibility

Because of the matter described in the Basis for Disclaimer of Opinion paragraph, we were not able to complete an audit in accordance with Philippine Standards on Auditing.

Basis for Disclaimer of Opinion

The company's management restricted us from observing the counting of the physical inventories and sending out requests for confirmation of accounts receivable to certain customers. The company's records did not permit the application of alternative auditing procedures regarding the inventories and accounts receivable. Consequently, we were unable to obtain all the information and explanations we considered necessary to satisfy ourselves as to the existence of inventories and accounts receivable.

Furthermore, included in interest bearing borrowings, under non-current liabilities, are amounts totaling P5 million that are due for settlement within the forthcoming fiscal year. Philippine Accounting Standard 1, "Presentation of Financial Statements," requires separate disclosure of amounts that are to be settled before and after the forthcoming fiscal year. Based on the latter, interest-bearing borrowings would have been stated at P15 million, short-term borrowings at P10 million and current liabilities at P25 million.

Disclaimer of Opinion

Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraphs above, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Example Report 7

Auditor's report with a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence; completeness of accounting records cannot be substantiated due to lack of control over sales; the possible effect of this inability to obtain sufficient appropriate audit evidence is deemed to be material and pervasive to the financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements

We were engaged to audit the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for ... *(remaining words are the same as illustrated in the management's responsibility paragraph – see Example Report 1 above).*

Auditor's Responsibility

Because of the matter described in the Basis for Disclaimer of Opinion paragraph, we were not able to complete an audit in accordance with Philippine Standards on Auditing.

Basis for Disclaimer of Opinion

The Company's sales are made entirely on a cash basis. The Company's accounting records for cash sales were not adequate for the purposes of our audit and, therefore, there were no satisfactory audit procedures that we could perform to obtain reasonable assurance that all cash sales have been properly recorded.

Disclaimer of Opinion

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Example Report 8

Auditor's report with an unmodified opinion; the report contains an emphasis of matter paragraph referring to a significant uncertainty related to pending litigation and an other matters paragraph referring to a material inconsistency with other information in the annual report containing audited financial statements.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements

We have audited ... *(remaining words are the same as illustrated in the introductory paragraph – see Example Report 1 above).*

Management's Responsibility for the Financial Statements

Management is responsible for ... *(remaining words are the same as illustrated in the management's responsibility paragraph – see Example Report 1 above).*

Auditor's Responsibility

Our responsibility is ... *(remaining words are the same as illustrated in the auditor's responsibility paragraphs – see Example Report 1 above).*

Opinion

In our opinion ... *(remaining words are the same as illustrated in the opinion paragraph – see Example Report 1 above).*

Emphasis of Matter

We draw attention to Note X to the financial statements, which appropriately describes the significant uncertainty related to the outcome of a lawsuit in which the company is the defendant. The lawsuit alleges infringement of certain patent rights and claims royalties and punitive damages in the amount of P10 million. Although the company acknowledges that there is significant uncertainty related to the outcome of the lawsuit, the company believes that it will be able to successfully defend its case and, accordingly, no provision for any liability that may result has been recognized in the financial statements.

Other Matters

In the Chairman's Report contained in the Annual Report, it is stated that the company has realized a relative increase in profitability this year over that of the prior year. While this statement is consistent with regard to earnings before interest, taxes, depreciation, and amortization (EBITDA), it is inconsistent with regard to profit for the year, which has decreased from last year.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Example Report 9

Auditor's report with an unmodified opinion; the report contains an emphasis of matter paragraph referring to a significant and unusual related party transaction.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements

We have audited ... *(remaining words are the same as illustrated in the introductory paragraph – see Example Report 1 above).*

Management's Responsibility for the Financial Statements

Management is responsible for ... *(remaining words are the same as illustrated in the management's responsibility paragraph – see Example Report 1 above).*

Auditor's Responsibility

Our responsibility is ... *(remaining words are the same as illustrated in the auditor's responsibility paragraphs – see Example Report 1 above).*

Opinion

In our opinion ... *(remaining words are the same as illustrated in the opinion paragraph – see Example Report 1 above).*

Emphasis of Matter

We draw attention to a significant and unusual related party transaction disclosed in Note X to the financial statements, which includes an appropriate description of the company's sale of the office equipment division to a member of the company's management team for P100 million.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Example Report 10

Auditor's report with an unmodified opinion; the report also contains an emphasis of matter paragraph referring to uncertainty regarding the effects of a major catastrophe.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements

We have audited ... *(remaining words are the same as illustrated in the introductory paragraph – see Example Report 1 above).*

Management's Responsibility for the Financial Statements

Management is responsible for... *(remaining words are the same as illustrated in the management's responsibility paragraph – see Example Report 1 above).*

Auditor's Responsibility

Our responsibility is ... *(remaining words are the same as illustrated in the auditor's responsibility paragraphs – see Example Report 1 above).*

Opinion

In our opinion ... (*remaining words are the same as illustrated in the opinion paragraph – see Example Report 1 above*).

Emphasis of Matter

We draw attention to Note X to the financial statements, which includes an appropriate description of the considerable uncertainties to which the calculation of the year's results and shareholders' equity at December 31, 20X1 are subject because of [*describe major catastrophe*]. Note X further gives a description of the fact that the company is in the process of restructuring due to the catastrophe, and a description of the related accounting treatment, including expectations for the company's future operations.

Report on Other Legal and Regulatory Requirements

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.*]

[*Auditor's signature*]

[*Date of the auditor's report*]

[*Auditor's address*]