



CHARTERED CERTIFIED ACCOUNTANTS

Reporting on Audit Clients

Auditors in the United Kingdom have a statutory responsibility to form an *independent* opinion on whether or not a reporting entity's financial statements represent a *true and fair* view. Note the term *independent* means an unbiased opinion.

This article considers some of the reports an auditor is obliged by statute to give when they have arrived at their opinion. This article will look at the auditor's opinion and illustrate these, using scenarios as to which type of report to give in particular circumstances.

The main opinions auditors give on financial statements in the UK and Ireland are:

- An unqualified opinion (internationally known as an unmodified opinion);
- A qualified opinion (internationally known as a modified opinion);
- An adverse opinion; and
- A disclaimer.

Unqualified opinions

Unqualified (unmodified) opinions sometimes cause confusion with students studying auditing papers because students often assume that a qualified audit partner gives the audit opinion, which of course s/he does, but the word 'unqualified' often causes confusion. The word 'unqualified' is nothing to do with the qualification status of the person issuing the report. Indeed, an unqualified accountant would not be able to obtain Registered Auditor status in the UK and Ireland. Therefore reference to the audit partner's qualifications (or possibly lack of) when referring to unqualified or qualified opinions will merely go to make the examiner/marker think you do not warrant a pass on the paper.

An unqualified audit opinion is merely the opinion the auditor gives when they are satisfied that the financial statements of a reporting entity give a *true and fair view*. Note that there is no legal definition of 'true and fair' in legislation but common sense tells us that the financial statements must be representative of the state of the company's affairs.

When the auditor arrives at the opinion that the financial statements give a true and fair view, they are not stating in their opinion that the financial statements are 100% accurate. What the auditors are saying in their opinion is that the financial statements are free from **material** misstatements, whether these misstatements have been caused by fraud or error.

Materiality levels are usually set at the planning stage of an audit and any misstatements discovered during the course of the audit which are below the materiality level set at the

planning stage do not have to be adjusted. However, if the misstatements discovered in the financial statements become material when aggregated (i.e. multiple misstatements below the materiality level in isolation but when added together they become material) then the financial statements will not give a true and fair view.

In these instances discussions must take place between the auditor and those charged with governance as soon as is reasonably practical to correct these misstatements. See *ISA 260 "The Auditor's Communication with those Charged with Governance"*.

Qualified opinions

The auditor will give a qualified audit opinion if they disagree with the treatment of an item(s) within the financial statements or if they disagree with a disclosure that has (or has not) been made within the financial statements.

A qualified opinion is, therefore, the auditor disagreeing that one or more items within the financial statements (may have) have caused them to be misstated. Note qualifications occur when the item(s) is/are material to the financial statements. In other words, an item is material if its omission or error from the financial statements would influence the decisions of the user(s) of the financial statements. The most common case of this is where an audit client refuses to write off a material bad debt which, in the auditor's opinion, should be written off.

Another reason that the auditor will give a qualified audit opinion is if the financial statements give rise to a 'limitation of scope'. A limitation of scope is where the auditor is unable to obtain all the necessary audit evidence to substantiate an item(s) within the financial statements.

Qualified opinions are usually followed by an 'except for' phrase which means that except for the qualification of a particular issue(s) then the rest of the financial statements will give a true and fair view.

Adverse opinions

These are potentially one of the worst opinions an auditor can give an audit client. An adverse opinion is where the auditor concludes that there is a material difference between what the financial statements are reporting and what the auditor's opinion of the accounts should show. In this case the accounts will not show a true and fair and this should be stated in the auditor's opinion.

Adverse opinions are quite rare, but do exist and auditor's will always try to find a solution with their audit client to correct the financial statements to avoid them giving an adverse opinion, if possible.

Disclaimer

A disclaimer opinion is given when the auditor cannot arrive at an opinion because of fundamental uncertainty. Disclaimers are also very rare, and are always given if no solution to the problem(s) within the financial statements can be found.

We shall now consider some illustrative scenarios to outline when a qualified opinion, an adverse opinion and a disclaimer is given. The following illustrations adopt the use of UK GAAP (FRS) and not IFRS/IAS.

Example 1

Alpha Limited has produced its financial statements for the year ended 31 December 2007. The financial statements comprise the profit and loss account, the balance sheet, the cash flow statement and the related notes. The closing stock figure at 31 December 2007 amounted to £1,400,000 – which is highly material to the financial statements.

The auditor was not appointed until 31 January 2007 and therefore did not attend the stocktake of the company at the year end 31 December 2007. The auditor has been able to obtain sufficient and appropriate audit evidence in relation to the opening balances as at 1 January 2007.

Example 2

Beta Limited has produced its financial statements for the year ended 31 December 2007. The company operates a defined benefit pension scheme and approached its actuaries for the relevant calculations to include the disclosure notes in the financial statements of the company.

The directors have refused to pay the fees to obtain the relevant calculations and have decided not to include the relevant disclosures in respect of the defined benefit pension scheme and as a result, the directors have not been able to include the pension fund deficit of £500,000 onto its balance sheet. This figure is highly material.

Example 3

Cosmo Limited has prepared its financial statements to 31 December 2007. This is the first year of trade. Mr Dodgy, the company's accountant implemented the internal control system. During the audit testing on the company's internal controls it became apparent that there were substantial failings in the internal control environment. The computer system used to manage the accounting of the business was administered on a "man-made" spreadsheet and it was later apparent that there was a substantial weakness in the controls relating to document flow of the business.

Audit reports to be issued in the above examples

Example 1

In example 1, the audit firm had not been appointed until one month after the year end. The audit firm had been able to obtain appropriate audit evidence to support the brought forward balances. However, as the audit firm had not attended the year-end stocktake and were unable to adopt alternative audit procedures to verify the closing stock figure and the existence of the actual stock at the year end 31 December 2007 they should issue a qualified audit report 'except for' as they could not satisfy themselves that the stock at the year end existed ('existence' being a financial statement assertion). *ISA 500 "Audit Evidence"* also requires the audit firm to attend the year end stocktake where the stock figure is material (or could be material if aggregated with other misstatements).

Example 2

In example 2, Beta had a defined benefit pension scheme. *FRS 17 "Retirement Benefits"* states that they should include the surplus or deficit of the defined benefit pension scheme on the balance sheet. In order to do this, the directors will need to obtain calculations from the actuarial firm. If the directors refuse and the pension scheme's deficit is not brought on to the company's balance sheet then the financial statements will not give a true and fair view and in this instance, an adverse opinion is required.

Example 3

In example 3 the auditor concluded that the internal control environment of Cosmo was nothing short of non-existent. In this case the auditor is unable to conclude whether or not the financial statements do give a true and fair on the grounds of fundamental failings in the control environment.

Another heading often used in audit reports is an 'emphasis of matter'. An emphasis of matter is not a qualification of an audit opinion. An emphasis of matter paragraph is included in the audit report when an unusual item occurs but which, in the opinion of the auditor, is fundamental and therefore requires disclosure to enable the user(s) of the financial statements to have a better understanding.

It is also worth noting that an 'emphasis of matter' paragraph does not affect the auditor's opinion on the financial statements. The auditor will include such a paragraph, for example, when the reporting entity is going through litigation and it is uncertain as the outcome. They would also include an emphasis of matter paragraph if they have unusual related parties or if there is a major catastrophe which seriously disrupts the business, but is not expected to occur again. These are just examples but the auditor should use their judgement when including these paragraphs within their audit report.

Conclusion

Audit reports, in recent years, have become extremely complex. The length of the audit report has more or less doubled over the last few years and auditors are becoming under more and more pressure from their professional institutes and also the Auditing Standards Board to be technically competent to undertake the correct procedures in order to arrive at an appropriate opinion and issue the correct audit report.

Steven Collings FMAAT ACCA is Audit Manager at Leavitt Walmsley Associates Ltd.