

The auditor's report on financial statements

The auditor is required to produce an **audit report** at the end of the audit which sets out his **opinion** on the truth and fairness of the financial statements. The report contains a number of **consistent elements** so that users know the audit has been conducted according to **recognised standards**.

ISA 700 *The auditor's report on financial statements* establishes standards and provides guidance on the form and content of the auditor's report issued as a result of an audit performed by an independent auditor on the financial statements of an entity. It states that the auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the **applicable financial reporting framework**.

In order to form the opinion, the auditor needs to conclude as to whether reasonable assurance has been obtained that the financial statements are free from material misstatement. The auditor's conclusion needs to consider the following.

- Whether **sufficient appropriate audit evidence** has been obtained (ISA 330)
- Whether **uncorrected misstatements are material** (ISA 450)
- **Qualitative aspects of the entity's accounting practices**, including indicators of possible bias in management's judgements
- Whether the financial statements **adequately disclose the significant accounting policies selected and applied**
- Whether the accounting policies selected and applied are **consistent** with the applicable financial reporting framework and are **appropriate**
- Whether **accounting estimates** made by management are **reasonable**
- Whether **the information** in the financial statements is **relevant, reliable, comparable and understandable**
- Whether the financial statements provide **adequate disclosures** to allow users to understand the effect of material transactions and events on the information presented in the financial statements
- Whether the **terminology** used in the financial statements is **appropriate**
- The **overall presentation, structure and content** of the financial statements
- Whether the financial statements represent the underlying transactions and events so as to achieve **fair presentation**
- Whether the financial statements **adequately refer to or describe the applicable financial reporting framework**

1.1 Unmodified auditor's report

An **unmodified opinion** is the opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

ISA 700 states that the auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

If the auditor concludes that the financial statements as a whole are not free from material misstatement or cannot obtain sufficient appropriate audit evidence to make this conclusion, the auditor must modify the opinion in accordance with ISA 705 *Modifications to the opinion in the independent auditor's report*. We discuss modifications to the opinion later in this section.

The following extract from an audit report shows an example of the opinion paragraph for an unmodified report, in accordance with ISA 700, which contains illustrations of unmodified auditors' reports in its appendix. The full unmodified report was also set out in Chapter 1 of this Study Text.

Opinion on financial statements

In our opinion the financial statements:

- Give a true and fair view of the state of the company's affairs as at and of its profit [loss] for the year then ended;
- Have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- Have been prepared in accordance with the requirements of the Companies Act 2006.

1.2 Basic elements of the auditor's report

A measure of **consistency** in the form and content of the auditor's report is desirable because it **promotes credibility** in the global marketplace and also helps to promote the **reader's understanding** and to **identify unusual circumstances** when they occur.

The auditor's report must be **in writing** and includes the following basic elements, usually in the following layout.

Basic elements of audit report	Explanation
Title	The auditor's report must have an appropriate title. The term "Independent Auditor" is usually in the title to distinguish the auditor's report from any report that might be issued by others, such as those charged with governance, or from the reports of other auditors who may not have to comply with the APB's Ethical Standards.
Addressee	The addressee will be determined by law or regulation, but is likely to be the shareholders. The Companies Act 2006 requires the auditor to report to the company's members because the audit is undertaken on their behalf.
Introductory paragraph	This shall identify the entity being audited, state that the financial statements have been audited, identify the title of each statement that comprises the financial statements being audited, refer to the summary of significant accounting policies and other explanatory notes, and specify the date or period covered by each statement comprising the financial statements.
Respective responsibilities of those charged with governance and auditors	An understanding of the respective responsibilities helps users of the report to understand the nature and context of the audit opinion. The report shall state that: • Those charged with governance are responsible for the preparation of the financial statements in accordance with the applicable financial reporting framework. • Those charged with governance are required to make significant accounting estimates and judgements and to determine the appropriate accounting principles and methods in the context of the applicable financial reporting framework. • The responsibility of the auditor is to audit and express an opinion on the financial statements in accordance with the applicable legal requirements and International Standards on Auditing (UK and Ireland), and that those standards require the auditor to comply with the APB's Ethical Standards for Auditors
Scope of the Audit	The report shall either: • Cross refer to a "Statement of the Scope of an Audit" that is maintained on the APB's website; or • Cross refer to a "Statement of the Scope of an Audit" that is included elsewhere within the annual report; or • Include the following description of the scope of an audit: "An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies used are appropriate to the entity's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by those charged with governance, and the overall presentation of the financial statements".

Opinion paragraph	If the auditor expresses an unqualified opinion on financial statements prepared in accordance with a true and fair framework (as is required by law in the UK), the opinion shall clearly state that the financial statements give a true and fair view.
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Basic elements of audit reports	Explanation
	- The auditor's opinion must indicate the financial reporting framework that has been used. In the UK and Ireland, these normally comprise: – "UK Generally Accepted Accounting Practice", which comprises applicable UK law and UK Accounting Standards as issued by the Accounting Standards Board (ASB); or – "International Financial Reporting Standards (IFRSs) as adopted by the European Union and applicable national law; or – "Generally Accepted Accounting Practice in Ireland", which comprises applicable Irish company law and the Accounting Standards as issued by the ASB.
Other reporting responsibilities	If the auditor is required by law to report on any other matters, this must be done in an additional paragraph below the opinion paragraph. If the auditor is required to report on any matters by exception, as is the case under UK law, the auditor shall describe these responsibilities on the heading "Matters on which we are required to report by exception" and incorporate a suitable conclusion in respect of such matters.
Auditor's signature	The report must contain the auditor's signature, whether this is the auditor's own name or the audit firm's name or both. Where the auditor of a UK company is a firm the report is signed by the senior statutory auditor (this is usually the engagement partner) in his or her own name for and on behalf of the firm.
Date of the report	The report must be dated no earlier than the date on which the financial statements have been approved by those charged with governance and the auditor has considered all necessary available evidence.
Auditor's address	The location where the auditor practises must be included.

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF XYZ LIMITED

We have audited the financial statements of (name of entity) for the year ended ... which comprise [specify the titles of the primary statements such as the Profit and Loss account, the Balance Sheet, the Cash Flow Statement, the Statement of Total Recognised Gains and Losses, the Reconciliation of Movements in Shareholders' Funds] and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

Respective responsibilities of directors and auditors

As explained more fully in the Directors' Responsibilities Statement [set out [on page ...]], the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's [(APB's)] Ethical Standards for Auditors.

Scope of the audit of the financial statements

Either:

A description of the scope of an audit of financial statements is [provided on the APB's website at www.frc.org.uk/apb/scope/UKNP]/[set out [on page ...] of the Annual Report].

Or:

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements.

Opinion on financial statements

In our opinion the financial statements:

- Give a true and fair view of the state of the company's affairs as at ... and of its profit [loss] for the year then ended;
- Have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- Have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- Adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- The financial statements are not in agreement with the accounting records and returns; or
- Certain disclosures of directors' remuneration specified by law are not made; or
- We have not received all the information and explanations we require for our audit.

[Signature]

John Smith (Senior statutory auditor)

for and on behalf of ABC LLP, Statutory Auditor

Address

Date

1.3 Modified reports

There are three types of **modified opinion**: a **qualified opinion**, an **adverse opinion**, and a **disclaimer of opinion**.

ISA 705 *Modifications to the opinion in the independent auditor's report* sets out the different types of modified opinions that can result. It identifies three possible types of modifications:

- A **qualified opinion**
- An **adverse opinion**
- A **disclaimer of opinion**

1.3.1 Types of modifications

Pervasiveness is a term used to describe the effects or possible effects on the financial statements of misstatements or undetected misstatements (due to an inability to obtain sufficient appropriate audit evidence). There are three types of pervasive effect:

- Those that are not confined to specific elements, accounts or items in the financial statements
- Those that are confined to specific elements, accounts or items in the financial statements and represent or could represent a substantial portion of the financial statements
- Those that relate to disclosures which are fundamental to users' understanding of the financial statements

The type of modification issued depends on the following:

- The **nature of the matter** giving rise to the modifications (i.e. whether the financial statements are **materially misstated** or whether they **may be misstated** when the auditor cannot obtain sufficient appropriate audit evidence)
- The auditor's judgement about the **pervasiveness** of the effects/possible effects of the matter on the financial statements

A modified opinion is required when:

- The auditor concludes that the financial statements as a whole are not free from material misstatements or
- The auditor cannot obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

1.3.2 Qualified opinions

A qualified opinion must be expressed in the auditor's report in the following two situations:

(1) The auditor concludes that misstatements are material, but not pervasive, to the financial statements.

Material misstatements could arise in respect of:

- The appropriateness of selected accounting policies
- The application of selected accounting policies
- The appropriateness or adequacy of disclosures in the financial statements

(2) The auditor cannot obtain sufficient appropriate audit evidence on which to base the opinion but concludes that the possible effects of undetected misstatements, if any, could be material but not pervasive. This is also known as a "limitation in scope".

The auditor's inability to obtain sufficient appropriate audit evidence is also referred to as a limitation on the scope of the audit and could arise from:

- Circumstances beyond the entity's control (e.g. accounting records destroyed)
- Circumstances relating to the nature or timing of the auditor's work (e.g. the timing of the auditor's appointment prevents the observation of the physical inventory count)
- Limitations imposed by management (e.g. management prevents the auditor from requesting external confirmation of specific account balances)

1.3.3 Adverse opinions

An adverse opinion is expressed when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements are both **material and pervasive** to the financial statements. For example, an adverse opinion might be issued if there is a material uncertainty in respect of going concern, which has not been adequately disclosed or use of the going concern assumption is inappropriate (we discussed this in Chapter 18).

1.3.4 Disclaimers of opinion

An opinion must be disclaimed when the auditor **cannot obtain sufficient appropriate audit evidence** on which to base the opinion and concludes that the **possible effects** on the financial statements of undetected misstatements, if any, **could be both material and pervasive**.

An example of when a disclaimer of opinion is used could be in relation to going concern if management is unwilling to make or extend its assessment (see Chapter 18).

The opinion must also be disclaimed in situations involving **multiple uncertainties** when the auditor concludes that, despite having obtained sufficient appropriate audit evidence for 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.

1.3.5 Impact on the auditor's report

When the auditor has had to modify the auditor's report, the report must include a paragraph before the opinion paragraph, which provides a description of the matter giving rise to the modification. This paragraph will be entitled 'Basis for qualified opinion' or 'Basis for adverse opinion' or 'Basis for disclaimer of opinion' depending on the type of modification.

The section of the auditor's report containing the opinion will be headed either 'Qualified opinion', 'Adverse opinion' or 'Disclaimer of opinion', again depending on the type of modification.

When the auditor expresses a qualified or adverse opinion, the section of the report on the auditor's responsibilities must be amended to state that the auditor believes that the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's modified audit opinion.

When the auditor disclaims an opinion due to being unable to obtain sufficient appropriate audit evidence, the section on the auditor's responsibilities must be amended to include the following: 'Because of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion'.

We will now look at some examples of extracts from modified auditor's reports for each of the situations we have discussed above.

Example 1: Qualified opinion due to material misstatement of inventories

Basis for qualified opinion

The company's inventories are carried in the balance sheet at xxx. Management has not stated inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from International Financial Reporting Standards. The company's records indicate that had management stated the inventories at the lower of cost and net realisable value, an amount of xxx would have been required to write the stock down to their net realisable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of ABC Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Example 2: Adverse opinion due to material misstatement because of non-consolidation of a subsidiary

Basis for adverse opinion

As explained in Note X, the company has not consolidated the financial statements of subsidiary XYZ Company it acquired during 20X1 because it has not yet been able to ascertain the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under International Financial Reporting Standards, the subsidiary should have been consolidated because it is controlled by the company. Had XYZ been consolidated, many elements in the accompanying financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the consolidated financial statements do not present fairly (or *do not give a true and fair view of*) the financial position of ABC Company and its subsidiaries as at December 31, 20X1, and (of) their financial performance and their cash flows for the year then ended in accordance with International Financial Reporting Standards.

Example 3: Qualified opinion due to inability to obtain sufficient appropriate audit evidence about an investment in a foreign affiliate (material but not pervasive)

Basis for qualified opinion

ABC Company's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at xxx on the balance sheet as at December 31, 20X1, and ABC's share of XYZ's net income of xxx is included in ABC's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC's investment in XYZ as at December 31, 20X1 and ABC's share of XYZ's net income for the year because we were denied access to the financial information, management, and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

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, (or *give a true and fair view of*) the financial position of ABC Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Example 4: Disclaimer of opinion due to inability to obtain sufficient appropriate audit evidence about a single element of the financial statements (financial information of a joint venture investment representing over 90% of company's net assets – material and pervasive)

Basis for disclaimer of opinion

The company's investment in its joint venture XYZ (Country X) Company is carried at xxx on the company's balance sheet, which represents over 90% of the company's net assets as at December 31, 20X1. We were not allowed access to the management and the auditors of XYZ, including XYZ's auditors' audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the company's proportional share of XYZ's assets that it controls jointly, its proportional share of XYZ's liabilities for which it is jointly responsible, its proportional share of XYZ's income and expenses for the year, and the elements making up the statement of changes in equity and cash flow statement.

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.

1.3.6 Communication with those charged with governance

ISA 705 states that when the auditor expects to express a modified opinion, the auditor must **communicate with those charged with governance** the circumstances leading to the expected modification and the proposed wording of the modification in the auditor's report.

This allows the auditor to give **notice** to those charged with governance of the intended modification and the reasons for it, to **seek agreement or confirm disagreement** with those charged with governance with respect to the modification, and to give those charged with governance an **opportunity to provide further information and explanations** in respect of the matter giving rise to the expected modification.

1.3.7 Summary of modifications and impact on the auditor's report

The following table summarises the different types of modified opinion that can arise.

<i>Nature of circumstances</i>	<i>Material but not pervasive</i>	<i>Material and pervasive</i>
Financial statements are materially misstated	QUALIFIED OPINION (Ex1)	ADVERSE OPINION (Ex2)
Auditor unable to obtain sufficient appropriate audit evidence	QUALIFIED OPINION (Ex3)	DISCLAIMER OF OPINION (Ex4)

1.4 Emphasis of matter paragraphs and other matter paragraphs in the auditor's report

Emphasis of matter paragraphs and **other matter paragraphs** can be included in the auditor's report under certain circumstances. Their use does not modify the auditor's opinion on the financial statements.

ISA 706 *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report* provides guidance to auditors on the inclusion of paragraphs in the auditor's report that either draw users' attention to a matter that is of such importance that it is **fundamental** to their understanding or that is **relevant** to their understanding of the audit, the auditor's responsibilities or the auditor's report.

1.4.1 Emphasis of matter paragraphs

An **emphasis of matter paragraph** is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements.

Emphasis of matter paragraphs are used to draw readers' attention to a matter **already presented or disclosed** in the financial statements that the auditor feels is **fundamental** to their understanding, provided that the auditor has obtained sufficient appropriate audit evidence that the matter is **not materially misstated**.

When an emphasis of matter paragraph is included in the auditor's report, it comes **immediately after the opinion paragraph** and is entitled 'Emphasis of matter' (or appropriate). The paragraph must contain a **clear reference** to the matter being emphasised and to where relevant disclosures that fully describe it can be found in the financial statements. The paragraph must state that **the auditor's opinion is not modified** in respect of the matter emphasised.

The following are examples of situations in which the auditor might include an emphasis of matter paragraph in the auditor's report:

- An uncertainty relating to the future outcome of **exceptional litigation or regulatory action**
- **Early application of a new accounting standard** that has a **pervasive effect** on the financial statements
- A **major catastrophe** that has had, or continues to have, a **significant effect** on the entity's financial position

ISA 706 contains an example auditor's report that contains an emphasis of matter paragraph, relevant extracts of which are shown below.

Emphasis of Matter

We draw attention to Note X to the financial statements which describes the uncertainty related to the outcome of the lawsuit filed against the company by XYZ Company. Our opinion is not qualified in respect of this matter.

1.8 The audit report as a means of communication

1.8.1 Implied information

Unmodified audit reports may not appear to give a great deal of information. The report says much, however, by implication. Remember that the auditors report *by exception*, so an unmodified report tells the user that:

- **Adequate accounting records have been kept.**
- **The accounts agree with the records.**
- **The auditors have received all necessary information.**
- **All directors' transactions have been disclosed.**
- **Returns adequate for audit were received from branches not visited.**

The real problem here is that, unfortunately, most users do not know that this is what an unmodified auditor's report tells them. This issue is also confused by the fact that many users do not understand the responsibilities of either the auditors or the directors in relation to the financial statements.

1.8.2 Expectations gap

This difference between the actual and the public perception is part of what is called the '**expectations gap**', defined as the difference between the apparent public perceptions of the responsibilities of auditors on the one hand (and hence the assurance that their involvement provides) and the legal and professional reality on the other. The question remains: how can we make the **meaning** of an unqualified audit report clear to the user?

The above definition of the expectations gap is not definitive but we can highlight some specific issues.

- (a) **Misunderstandings of the nature of audited financial statements**, for example that:
- The balance sheet provides a fair valuation of the reporting entity.
 - The amounts in the financial statements are stated precisely.
 - The audited financial statements will guarantee that the entity concerned will continue to exist.
- (b) **Misunderstanding as to the type and extent of work undertaken by auditors**
- (c) **Misunderstanding about the level of assurance provided by auditors**, for example that:
- An unmodified auditor's report means that no frauds have occurred in the period.
 - The auditors provide absolute assurance that the figures in the financial statements are correct (ignoring the concept of materiality and the problems of estimation).

The APB published a revision to ISA 700 in March 2009 in order to facilitate a more concise auditor's report. This addresses changes introduced by the Companies Act 2006 and calls for the auditor's report to be more concise and informative for users. The APB has subsequently re-structured the standard in line with the clarity principles.

