Chapter 6

TYPES OF AUDIT REPORT: MODIFIED/ UNMODIFIED

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1. Unmodified

Now we are going to look at the types of audit report that exist.

First and simplest is the unmodified audit report. This is the audit report that you have seen with Tesco. Amongst the all the additional paragraphs, it simply states that the financial statements show a true and fair view. There are no 'ifs', 'buts' or additional information provided. Once this starting point is departed from, the audit report becomes modified and there are two types of modified audit report.

- Unmodified, or
- Modified

Modified

Matters that do not affect the auditor's opinion	Matters that do affect the auditor's opinion
Emphasis of matter, material uncertainty related to going concern and other matters	• FS do contain a material misstatement; or • Unable to obtain sufficient appropriate audit evidence to conclude FS free from material misstatement Qualified = 'except for' Disclaimer = unable to form an opinion Adverse = the FS do NOT show a true and fair view

As set out in the diagram above, the audit report can then be modified in several ways:

- Emphasis of matter. In respect of matters that do not affect the auditor's opinion. In other words, the auditor will still state that the financial statements show a true and fair view. However, the auditor wants to emphasis some matter. In other words, to make sure that some matter **already properly disclosed in the financial statements** is brought to the members' attention. The auditor is frightened that something which has been properly disclosed in the notes may be overlooked by the users of the financial statements and therefore that they get a misleading impression. So, the auditor is simply wishing to emphasise those matters. It's like waving a red flag. This is **not** a modification of the audit opinion.
- Other matters. Refers to a matter not in the financial statements, but which appears to be wrong. Typically this is used to point out that a statement by the directors in their report is inconsistent with the financial statements. The auditors cannot issue a qualified opinion because the director's report is not part off the financial statements. An 'other matter' paragraph not a modification of the audit opinion.
- Other types of modification are for matters which do affect the auditor's opinion and where the audit opinion is modified. There is something wrong in the financial statements, they contain a misstatement, or there is something about which the auditor has been unable to obtain sufficient appropriate audit evidence. Here the financial statements will either not show a true and fair view, or the auditor will be unwilling to express an opinion, or the auditor may include a phrase pointing out there are certain aspects in the accounts about which there is uncertainty or disagreement.

2. Emphasis of matter and other matters

An emphasis of matter modification is where there is a paragraph in the auditor's report which draws attention to some matter already properly disclosed within the financial statements. Such a paragraph is not a qualification: it is simply drawing attention to an important note in the financial statements that shareholders ought to be aware of to properly appreciate the financial statements.

Here is an example:

> "Without qualifying our opinion above, we draw attention to Note 10 to the financial statements. Five days before the directors formally approved the financial statements, the company received notification that they are to be named as defendants in a proposed legal action ….
>
> At this early stage it is not possible to estimate the ultimate outcome of... this matter, and no provision has been included within the financial statements."

Note that the financial statements do contain a note explaining this legal action. The financial statements are therefore as comprehensive and as open as they can be. But obviously if the legal action could end up on a large liability, to properly understand the company's future, you need to be aware that this action is pending.

Therefore the auditors use the audit report to emphasise this matter (and remember many people don't get far past the audit report and very few pore over the notes) and to draw users' attention to it.

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As said above, an other matter refers to something which is NOT in the financial statements, nor should be. The commonest example is when something in the directors' report contradicts what is in the financial statements and the auditor should point out the discrepancy in case users are misled by the directors' claims. Therefore an other matters paragraph is added to explain the contradiction.

The emphasis of matter paragraph comes directly after the basis of opinion paragraph. It is emphasises again that these do not mean that the financial statements are 'qualified', wrong or in any way criticised.

The other matter paragraph comes directly after the Key Audit Matters paragraph. It doe also not cause the audit opinion to be modified.

3. Going concern

If there is a serious doubt relating to going concern this is headed up in a separate paragraph **"Material Uncertainty Related to Going Concern"**

For example:

We draw attention to Note 6 in the financial statements, which indicates that the Company incurred a net loss of ZZZ during the year ended December 31, 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. As stated in Note 6, these events or conditions, along with other matters as set forth in Note 6, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

Generally if the directors or the auditors think the company might not survive into the foreseeable future there is a going concern problem. 'Foreseeable future' is not defined but under IFRS is should not be less than 12 months form the end of the accounting period. UK GAAP specifies that is should not be less than 12 months form the date of approval of the FS.

It is for management to make an assessment of an entity's ability to continue as a going concern. The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

If events or conditions have been identified that cast significant doubt on the entity's ability to continue as a going concern, the auditor must obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

Evidence can consist of:

- Evaluating management's plans for future actions in relation to its going concern and whether the outcome of these plans are feasible and likely to improve the situation
- Where the entity has prepared a cash flow forecast:
    - Evaluating the reliability of the underlying data generated to prepare the forecast; and
    - Determining whether there is adequate support for the assumptions underlying the forecast.
- Considering whether any additional facts or information have become available since the date on which management made its assessment.
- Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans.

If there is no realistic prospect of the company surviving then the FS should be drawn up on a break-up basis. Then all sorts of issues are going to arise over valuation of assets and the payment of a certain statutory liabilities to employees.

Signs that the company may have going concern difficulties include the following:

- Negative operating cash flows.
- An inability to pay suppliers when due (and auditors are usually rather sensitive if they see that the payment of creditors has slowed down, so that the company is borrowing more from its suppliers).
- Operating losses. These do not mean that the company is going to fail immediately; going concern tends to be rather more concerned with cash. An operating loss can be sustained for a number of years provided that cash doesn't run out. In the longer term, losses usually result in cash flow problems.
- If the borrowing facilities are coming to an end and the new ones haven't been agreed, what's the company going to do to repay the loan, when no cash is available?
- The loss of key staff or key customers can mean the company is unable to trade or unable to sell its products.
- Technology changes can render the company's purpose and main product redundant. Legislative changes may mean that the company's operations become illegal or the company has to go through some sort of regulatory requirements before it can continue trading and that this is going to be difficult for it.
- Non-compliance with regulations may mean a business loses its right or license to trade and in such a case the company may simply have to be wound up. Non-compliance can also result in crippling penalties and harmful damage to the organisation's reputation.

4. Effect of going concern problems on the audit report

So what are the effects of going concern issues on the audit report? If the worries are fully disclosed in a note to the financial statements, then it will be appropriate for an emphasis of matter paragraph to appear in the audit report to refer uses to the note. The financial statements are not qualified, assuming that the auditor feels that drawing up those accounts on a going concern basis is fair. The accounts are open and upfront about admitting with a going concern problem, and the emphasis of matter is used to make sure that uses of the accounts do not overlook this important piece of information.

If the going concern worries are not disclosed then the financial statements cannot be true and fair and they are effectively concealing something which is important for the proper understanding of them. In such a case modified opinion will be appropriate.

A modified opinion would also be appropriate if the auditor felt that it was wrong to draw up the financial statements on a going concern basis. That would happen if the company was in such a precarious position that it had no realistic chance of survival.

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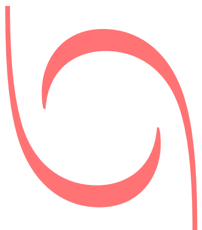

5. Modified audit opinions

With respect to modified opinions there are two potential reasons for modification:

- FS contain a material misstatement
- The auditor has been unable to obtain sufficient appropriate audit evidence.

There are two degrees of seriousness for each of these problems

First let's look at material misstatement. This is where the auditor disagrees with the figure in the financial statements. It could be the figure itself or the way the figure is presented or the disclosures which must be made to comply with accounting standards. First of all, if the misstatement is not a material the audit opinion would not be modified, so the first hurdle is a that disagreement must be for a material amount. In such a case the auditor would put a paragraph in the report saying **except for** certain items in other respects the financial statements show a true and fair view: the opinion has been qualified.

If however the misstatement is so large and so material that it renders the financial statements, useless then the auditor would issue **an adverse** opinion and the auditor would say the financial statements do not show a true and fair view.

The other reason for a modified opinion is where the auditor has been unable to obtain sufficient appropriate audit evidence.

For some reason the auditor has not been able to get all the information required to draw the proper conclusions. If the matter about where there is missing information is relatively small but material then the auditor will qualify the accounts using **an except-for** paragraph. For example, except that we could not verify the adequacy of the bad debt provision, the financial statements showed a true and fair view. If, however, the missing information is so large that the auditors really have no idea whether the financial statements showed a true and fair view, then they will issue **a disclaimer of** opinion stating that they are unable to form any opinion on the accounts.

The choices can be described in a matrix. Think of 'pervasive' as an error or gap in evidence that affects everything:

Nature of circumstance	Material but not pervasive	Pervasive
FS contain a material misstatement	A qualified opinion: Except for ...	Adverse opinion
Unable to obtain sufficient, appropriate evidence	A qualified opinion: Except for ...	Disclaimer of opinion

6. Example of insufficient appropriate audit evidence

Here is an example of a qualification because insufficient appropriate audit evidence that that makes it difficult to say that the financial statements show a true and fair view. Here the problem is material, but limited and the report says the auditors are unable to determine the inventory quantities and then says in their opinion, except for the effects of such adjustments for inventory, if any, the financial statements give a true and fair view. So this is an 'except for': the financial statements are showing a true and fair view except for one particular item which is material enough to cast some doubt on them.

> …Except as discussed in the following paragraph…
>
> We did not observe the counting of inventories at 31/12/200X…unable to determine inventory quantities by other methods…
>
> In our opinion, except for the effects of such adjustments to inventory, if any, had we been able to satisfy ourselves as to physical inventory…. The financial statements give a true and fair view.

7. Example of disclaimer of opinion

Here is a modified opinion caused by lack of sufficient appropriate audit evidence but which is leading to disclaimer of opinion. The cause of the problem is the same ie difficulty in verifying physical inventories, but here because of the significance of the inventories the auditors prefer to say that they cannot express an opinion on the financial statements.

> …Except as discussed in the following paragraph…
>
> We were not able to observe all physical inventories at 31/12/200X…unable to determine inventory quantities by other methods…
>
> Because of the significance of the matters discussed…we do not express an opinion on the financial statements.

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8. Material misstatement/'except for'

> As discussed in paragraph 17, no depreciation has been provided…….not in accordance with International Accounting Standards…
>
> The provision for the year should have been £X….profits would be decreased by £Y.
>
> In our opinion, except for the matter referred to above, the financial statements give a true and fair view…

Here is an example of a qualified opinion caused by the auditors believing that there is a material misstatement about something in the financial statements. Here the problem is that no depreciation has been provided where they think it should have been. Note, where there is a material misstatement auditors will normally be able to quantify its extent and the effect on the profits and is useful to the members for them to do that. Here the amount of depreciation in dispute is material, but not so great that it has made the financial statements not show a true and fair view.

9. Material misstatement/'adverse opinion'

Finally, a modified opinion caused by a material misstatement but it is so large that the auditors feel the financial statements do not give a true and fair view. Here the matter in dispute is about the provision for a bad or irrecoverable debt and the auditors feel the amount of $10 million which is not been provided for is of such significance that the financial statements do not show a true and fair view.

> As discussed in paragraph 15, no provision for irrecoverable debts has been established for a major customer owing $10 million and who has gone into liquidation with little prospect of substantial recovery of amounts owed. This provision would reduce profits and receivables by $10 million.
>
> In our opinion, because of the effects of the matter referred to above, the financial statements do not give a true and fair view.

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