

## **1 Modified auditors' reports (Lecture A693 – 12.54 minutes)**

An auditor will usually only express a modified (qualified) audit opinion as a last resort as they will give the client ample opportunity to resolve the issue(s) giving rise to the modified opinion, provided that it is in the control of the client.

However, in some situations, the auditor may conclude that:

- based upon the evidence obtained, the financial statements as a whole are not free from material misstatement whether caused by fraud or error. In such cases, the entity will not have complied with the applicable financial reporting framework; or
- the auditor has been unable to obtain sufficient appropriate audit evidence to enable them to conclude that the financial statements as a whole are free from material misstatement whether caused by fraud or error.

The nature of the opinion expressed in the auditor's report will depend on whether the issue is material or material and pervasive.

### **1.1 Material but not pervasive**

A matter is considered material, but not pervasive, when the issue only affects an isolated area of the financial statements. Examples include:

- capitalisation of research expenditure in contravention of FRS 102, para 18.8C;
- failing to disclose a material related party transaction;
- not attending the inventory count (where the inventory balance is material) because the auditor was appointed after the year end date had passed; and
- failing to make a provision for material unpaid holiday pay at the year end.

Where the client refuses to correct a material but not pervasive misstatement, the auditor expresses a qualified 'except for' opinion which states that 'except for' the effects of the material misstatement, the financial statements otherwise give a true and fair view. The Basis for Modified Opinion paragraph will then describe the nature of the modification in more detail and quantify the effects where applicable or possible.

### **1.2 Material and pervasive**

A matter is considered 'pervasive' if, in the auditor's judgement:

- the effects are not confined to specific elements, accounts or items of the financial statements;
- if so confined, represent or could represent a substantial proportion of the financial statements; or
- in relation to disclosures, are fundamental to users' understanding of the financial statements.

Hence, a pervasive matter must be fundamental to the financial statements therefore rendering them unreliable as a whole.

#### **Example**

A large private company operates a defined benefit pension plan for its employees and has a year end of 31 December 2019. Due to a dispute with the actuarial firm, the company has refused to commission a valuation for financial reporting purposes of the pension scheme. The pension scheme is significantly material to the financial statements and the directors are insistent that they will not obtain a valuation.

As the accounting input and disclosures are expected to be material and affect multiple areas of the accounts, i.e. the balance sheet for the resulting surplus/deficit, profit and loss account for the interest charge and current/past service cost and other comprehensive income for actuarial gains and losses and expected return on plan assets, together with the disclosure notes required under Section 28 of FRS 102, it can be said that the misstatements would be both material and pervasive.

### **1.3 Qualified 'except for' for opinion**

A qualified 'except for' opinion is expressed by the auditor when the issue giving rise to the modification is material but not pervasive. The auditor's opinion states that 'except for' the matter the matter, the financial statements give a true and fair view – in other words the matter is material to the area of the financial statements affected, but does not affect the remainder of the financial statements.

The Basis for Qualified Opinion paragraph will describe the effects of the issue, together with quantification where appropriate.

#### **Example**

A company operates in the pharmaceutical industry and has a significant amount of capitalised development expenditure on its balance sheet. The company reports under full FRS 102 and has a year end of 30 September 2019. During the year the company capitalised an amount of £450,000 worth of development expenditure which is considered significantly material to the financial statements. No amortisation has been charged on the additional development expenditure as the project was still nearing completion at the year end.

During the audit fieldwork, the auditor discovered that of the £450,000 worth of additions to intangible fixed assets, £220,000 was, in fact, research expenditure which should have been written off to the profit and loss account per paragraph 18.8E of FRS 102. The auditor concludes that this amount is material to the financial statements. Management have refused to correct this misstatement on the basis that they disagree with the auditor's conclusion and

the auditor disagrees with management that it should be capitalised. All other misstatements identified during the audit have been corrected.

In this example, the auditor disagrees with management's accounting treatment of the research expenditure. Assets and profit are overstated but the misstatement, despite being material, is not pervasive. The auditor concludes that the requirements of FRS 102 have not been complied with and hence will express a qualified opinion as follows:

**Qualified opinion**

We have audited the financial statements of ...

In our opinion, except for the matter described in the Basis for qualified opinion section of our report, the accompanying financial statements:

- give a true and fair view of the state of the company's affairs as at 30 September 2019 and of its profit for the year the 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.

**Basis for qualified opinion**

The company has recognised an amount of £220,000 of research expenditure as capitalised development expenditure on the balance sheet as at 30 September 2019 which, in our opinion, is not in accordance with the requirements of FRS 102. The company should have recognised the research expenditure in profit and loss for the year ended 30 September 2019 to comply with paragraph 18.8E of FRS 102. Accordingly, the company's intangible fixed assets should be reduced by an amount of £220,000 with a corresponding reduction in profit.

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of our report. We are independent of the company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

#### 1.4 Adverse opinion

An adverse opinion is expressed when a misstatement is considered to be material and pervasive. This will mean that the financial statements do not give a true and fair view. Examples of such issues include:

- preparing the financial statements on a going concern basis when the going concern basis of accounting is inappropriate;
- non-consolidation of a subsidiary; or
- material misstatement of a balance which represents a substantial proportion of the assets or profits and would, perhaps, turn a profit into a loss.

#### Example

Purley Enterprises Ltd has prepared its financial statements for the year ended 31 October 2019 on a going concern basis. On 14 November 2019, the bank confirmed that they would no longer be willing to support the company as it had defaulted on its loan terms, breached its overdraft facility on a number of occasions during the year and had failed to supply the bank with management accounts as requested. In addition, the company had entered into an arrangement with HMRC to pay an accelerated payment notice in respect of a tax avoidance scheme over a period of six months, but the company was already in arrears and HMRC have threatened to issue winding up proceedings.

The director has approached a number of other banks who have refused to help the company but is confident that eventually the company will find a bank to support it. The auditor has concluded that the going concern basis of accounting is inappropriate. The director has refused to have the financial statements prepared on a basis other than the going concern basis of accounting as he feels this may influence the decision of any potential lender.

Paragraph 21 of ISA (UK) 570 *Going Concern* says that if the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgement, this basis is inappropriate, the auditor must express an adverse opinion. This is because the effects of the inappropriate use of the going concern basis of accounting are both material and pervasive. The adverse opinion will be expressed as follows:

#### Adverse opinion

We have audited the financial statements of ...

In our opinion, because of the significance of the matter discussed in the Basis for adverse opinion section of our report, the financial statements:

- do not give a true and fair view of the state of the company's affairs as at 31 October 2019 and of its loss for the year then ended;
- have not been properly prepared in accordance with United Kingdom General Accepted Accounting Practice; and

- have not been prepared in accordance with the requirements of the Companies Act 2006.

**Basis for adverse opinion**

As explained in note 3 of the financial statements, the financial statements have been prepared on the going concern basis. However, in our opinion, due to the number and significance of the material uncertainties, the company is not a going concern in accordance with paragraph 3.8 of FRS 102 and therefore the financial statements should not be prepared on the going concern basis. Following a breach of the company's loan terms and overdraft facility, the company's bank has expressed their unwillingness to support the company and the directors have so far been unable to source financiers to continue to support the business. In addition, the terms of an arrangement to pay with HMRC in respect of a tax avoidance scheme has also not been complied with.

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of our report. We are independent of the company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

**1.5 Disclaimer of opinion**

A disclaimer of opinion is issued when the auditor is unable to form an opinion on the financial statements and the effects of any possible misstatements could be pervasive. Examples of situations giving rise to a disclaimer of opinion include:

- a failure by the client to keep adequate accounting records;
- refusal by the directors to provide written representations; or
- a failure by the client to provide evidence over a single account balance which represents a substantial proportion of the assets or profits or over multiple balances in the financial statements.

Disclaimer of opinions are rare in practice, but they do arise. Where a disclaimer of opinion is issued:

- the statement that sufficient appropriate audit evidence to provide a basis for the auditor's opinion is not included;
- the statements regarding the audit being conducted in accordance with ISAs (UK) and independence and other ethical responsibilities are positioned within the auditor's responsibilities section and not the Basis for Disclaimer of Opinion paragraph; and

- the key audit matters section (where applicable) is not included in the auditor's report as to do so would suggest the financial statements are more credible in respect of those matters which would be inconsistent with the disclaimer of opinion on the financial statements as a whole.

Keep in mind that a disclaimer of opinion is **not** an audit opinion – it confirms that the auditor cannot form an opinion on the financial statements.

### Example

A wholly-owned subsidiary has prepared its financial statements using the going concern basis of accounting for the year ended 31 July 2019. Management of the subsidiary have prepared the financial statements on the going concern basis of accounting on the grounds that the parent of the group itself will support the business. The auditor of the subsidiary has discussed the issue with the group auditor who has confirmed that the group has a significant level of overdue debt owed to it and, in the group auditor's opinion, the group nor the parent, has been able to produce any detailed projections, in the form of budgets or forecasts, which demonstrate the group's ability to continue as a going concern. The subsidiary is reliant on additional finance/investment which has not yet been secured.

Based on these facts, the auditor has concluded that they are unable to form an opinion as to whether the going concern basis of accounting is appropriate and has expressed a disclaimer of opinion which is expressed as follows:

#### **Disclaimer of opinion**

We have audited the financial statements of ...

We do not express an opinion on the accompanying financial statements. Because of the significance of the matter described in the Basis for disclaimer opinion section of our report, we have not been able to obtain sufficient appropriate evidence to provide a basis for an audit opinion on these financial statements.

#### **Basis for disclaimer of opinion**

The audit evidence available to us to confirm the appropriateness of management's use of the going concern basis of accounting was limited because the company is reliant on support from the Group. The Group has not been able to provide any corroboratory evidence that it is able to continue to trade for the foreseeable future as a going concern. The Group has significant levels of indebtedness and has not provided any financial projections which would indicate that it has the ability to continue to trade as a going concern for the foreseeable future.

As a result, we were unable to determine whether the going concern basis of accounting is appropriate in the company's circumstances.

### **Auditor's responsibilities for the audit of the financial statements**

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of our report. We are independent of the company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. However, because of the matter described in the Basis for disclaimer of opinion section of our report, we were not able to obtain sufficient appropriate evidence to provide a basis for an audit opinion on these financial statements.

### **1.6 Summary of opinions**

The table below provides a high level overview of the auditor's opinion on the financial statements when a modified opinion is to be expressed:

	<b>Material but not pervasive</b>	<b>Material and pervasive</b>
Financial statements contain material misstatement	<ul style="list-style-type: none"><li>• Qualified opinion</li><li>• Except for ...</li><li>• Basis for qualified opinion paragraph</li></ul>	<ul style="list-style-type: none"><li>• Adverse opinion</li><li>• Financial statements do not give a true and fair view</li><li>• Basis for adverse opinion paragraph</li></ul>
Auditor unable to obtain sufficient appropriate audit evidence	<ul style="list-style-type: none"><li>• Qualified opinion</li><li>• Except for ...</li><li>• Basis for qualified opinion paragraph</li></ul>	<ul style="list-style-type: none"><li>• Disclaimer of opinion</li><li>• Do not express an opinion</li><li>• Basis for disclaimer of opinion paragraph</li></ul>