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[Source:] https://www.businessbythebook.com.au/post/category/annual-reporting

[Two things that might surprise you about an audit report]

In reading this post, please keep its age in mind.

If you read one thing in the audit report, either in the annual report or with a set of financial statements, it's probably the section headed 'Opinion'. And in most cases auditors will say there that '*the financial report presents fairly, in all material respects'* or '*gives a true and fair view of'* the financial position, financial performance and cash flows of the organisation. And you say to yourself 'Oh good, everything's OK.' Maybe, maybe not. Here's two things that most people don't realise about such an opinion.

It's not a clean bill of health for the organization

In fact it's not an opinion on the organisation at all. It's a report on the financial report, not on the organisation itself. (And on the financial report, not its components.)

So if you are trying to assess the health of the organisation, or some aspect of it – and that would be normal – then what you should do is to take that report, and the opinion, and put them together with other information about the organisation and form your own opinion.

But even with the auditor's opinion on the financial report, there's something you need to realise.

It's not even a clean bill of health for that report

This is not a criticism of your auditor, it's just the nature of an audit. You see, when we say 'presents fairly, in all material respects' or 'gives a true and fair view of', we are not saying that the information is correct and unbiased, but that it is **materially** correct and unbiased.

Because of the processes involved in both the production of the report, and its audit, it is highly likely that there are misstatements in the report. 'Materially' here means that the auditor has decided that any such misstatements should not affect the decisions you make based on the report. It's about the decisions you make, not the accuracy of the report.

Not only this, but because of the inherent limitations of an audit, there is a chance that there are not only immaterial misstatements in the financial report, but also **material** misstatements. But this risk is low enough to allow us to issue a clean opinion.

What we are saying is that the report is accurate enough. In audit language, it provides 'reasonable assurance' rather than absolute assurance.

The bottom line is that you should take the audit opinion for what it is: an opinion on the financial report as a whole, a report that is now part of the history of the organisation, and an opinion that the risk of undetected material misstatements in that report is low. Therefore you'll need more than the audited financial report if you are considering a significant transaction with the organisation.

PUBLISHED: 31/07/2014 BY: Ted Sherwood IN : Annual reporting

Did you get a clean one? A guide to the audit result

In reading this post, please keep its age in mind.

An audit report may be required in your organisation, so OK, you get one. But that shouldn't be the end of it. Audits were demanded by owners before they were mandated by governments, so they should tell you something of value.

But the report's not in ordinary English, so where to start? (If this is you as part of management or as a member of the governing body of the organisation, then hopefully the auditor has explained what I'm about to explain before the report is issued; if you are a member, then you'll need the information when the annual financial statements are sent to you.)

First we need to set the scene. The purpose of the audit, from your point of view, is to give you greater confidence in the financial report, a report prepared by those internal to the organisation. It's an independent expert opinion, by a (usually professional) accountant, on whether or not the report deviates from what it is meant to have done.

Technically, this is the task of the auditor:

The auditor shall form an opinion on whether the financial report is prepared, in all material respects, in accordance with the applicable financial reporting framework[i].

So it's not quite all deviations, only those that are 'material'. The word 'material' here has a big influence on a correct understanding of the confidence you can take from an audit. Information is 'material' if, when

omitted, misstated or not disclosed, that information has the potential to affect the economic decisions of users of the financial report or the discharge of accountability by management or those charged with governance[ii].

So if the auditor doesn't think that the information 'omitted, misstated or not disclosed' will change a decision you are going to make based on the financial report, or change whether you think those responsible for the report have given a satisfactory account of their stewardship, then they can still give a clean opinion.

The other term you need to understand is ‘applicable financial reporting framework’:

[This] is represented by the Australian Accounting Standards issued by the Australian Accounting Standards Board (AASB), and relevant law, such as the Corporations Act 2001, (*the Act) for entities covered by that Act, or other relevant law that may be applicable to other entities*[iii].

Back to the audit report then. I’d start by seeing what opinion the auditor has given you. It should be under a heading *Opinion* towards the end of the report. Is it a ‘clean’ opinion? This is where the auditor issues an unqualified report, a report that is unmodified from a standard report. The simplest type has a paragraph like this:

In our opinion: The financial report presents fairly, in all material respects [or ‘gives a true and fair view of] …in accordance with [the applicable financial reporting framework][iv].

This, even though the opinion is heavily qualified by the phrase ‘in all material respects’, is the best result you can get.

An unmodified opinion may however also include two other paragraphs that are part of the opinion.

An ‘Emphasis of Matter paragraph’, which should be a separate heading after the opinion,

refers to a matter appropriately presented or disclosed that, in the auditor’s judgement, is of such importance that it is fundamental to users’ understanding of the financial report’[v].

The possibility that such a paragraph is included is one reason why it is a good idea to turn to the audit report first when reading the financial statements.

The other paragraph that you may see in an unmodified opinion, usually under its own heading after the Emphasis of Matter paragraph, is called an ‘Other matter paragraph’. This is about something that, although it is not in the financial report, the auditor judges ‘is relevant to your understanding of the audit, his responsibilities, or his report’[vi]. If the auditor cannot give the report a ‘clean’ opinion they modify their opinion.

Modified opinions

The auditor is required to modify their opinion when they can’t make the simple statement in the clean opinion above[vii].

There are three possibilities: a qualified opinion, an adverse opinion, and a disclaimer of opinion[viii]. If the audit report you are reading is a modified opinion, the heading on the paragraph giving the opinion, instead of merely saying ‘Opinion’ (see above) will describe the type of modified opinion, either ‘Qualified Opinion’, ‘Adverse Opinion’, or ‘Disclaimer of Opinion’[ix].

Adverse opinion

‘Adverse’. Doesn’t sound good does it? The main synonym is ‘unfavourable’, so this is an opinion that should rock your confidence in the financial report. Let’s see why.

The auditor will issue an adverse opinion if they think that the financial report is not only materially misstated, but that the misstatements are ‘pervasive’[x]. There’s a technical definition but the main synonym, ‘all encompassing’ will give you the idea.

Whenever the auditor modifies his opinion they have to include an additional paragraph, immediately above the opinion paragraph, and headed ‘*Basis for Adverse Opinion*, that describes the matter causing the modification[xi]. Even without this, though, you should be worried about the accounting system, including personnel, which generated a financial report that got an adverse opinion.

Qualified opinion

If the auditor thinks that the report is materially misstated, but that the misstatements are not ‘pervasive’, then they will issue a qualified opinion. This means that they will say that the report does present the position and performance fairly, except for the material misstatement or misstatements. And will include an extra paragraph, headed ‘*Basis for Qualified Opinion,* describing the issue. It is therefore up to you, the reader, to use this information to adjust your judgements about the condition of the organisation, including its accounting system.

The auditor should also issue a qualified opinion if, in doing the audit, they experienced a material, but not ‘pervasive’, inability to get enough audit evidence on which to base their opinion[xii].

Disclaimer of opinion

The final situation that will give rise to a modified opinion is where this inability is both material and pervasive. This opinion is called a disclaimer of opinion (and therefore not really an opinion at all is it?). The auditor just couldn’t get enough information to form an opinion[xiii].

My opinion

Hopefully you can now see that, although you’ve got an audit report (or draft if you are the CEO), it contains a very important opinion, one that you should read carefully and then, if necessary, ask the appropriate people some appropriate questions.

[i]Auditing Standard ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*, Auditing and Assurance Standards Board, October 2009, paragraph 11.

[ii]AUASB Glossary, Auditing and Assurance Standards Board, October 2009.

[iii]ASA 200, paragraph Aus A5.1.

[iv]Auditing Standard ASA 700 *Forming an Opinion and Reporting on a Financial Report*, Auditing and Assurance Standards Board, July 2013, paragraph 35.

[v]Auditing Standard ASA 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report,* Auditing and Assurance Standards Board, paragraph 5.

[vi]ASA 706, paragraph 5.

[vii]ASA 700.

[viii]Auditing Standard ASA 705 Modifications to the Opinion in the Independent Auditor's Report, Auditing and Assurance Standards Board, June 2011, paragraph 2.

[ix]ASA 705, paragraph 22.

[x]ASA 705, paragraph 8.

[xi]ASA 705, paragraph 16.

[xii]ASA 705, paragraph 7.

[xiii]ASA 705, paragraphs 9-10.

PUBLISHED: 10/07/2014 BY: Ted Sherwood IN : Annual reporting