Understanding audit report modifications

In an earlier article we looked at overcoming some of the misconceptions surrounding audits and introduced the most visible summary of an auditor's work: the audit report. While a standard format exists audit reports can also contain many differences. But what are these differences, what causes them and what are the implications?

A great example of good governance in action is an independent audit report on an entity's annual financial statements. It is an important part of reliable financial reporting.

The audit report is the summary of a detailed process undertaken to ensure that all the details relating to an organisation's financial transactions were correctly, accurately and honestly recorded in their financial statements. By its very nature it provides an increased level of comfort and assurance to any party that relies on the information contained within a set of financial statements. While an audit is certainly not the panacea it is an important step to ensuring reliable financial reporting, which in turn assists better financial governance of an organisation.

The word "qualification" in most common usage usually indicates something positive. A university qualification for example is the crowning achievement for years of applied effort and hard work. However, this is not so for audits. If an auditor is required to qualify their opinion contained in their audit report then, depending upon the nature of the qualification, the auditor is in effect saying there is something wrong with either the financial information, or flagging that the reliance that can be placed on their work as independent auditors is limited.

Our firm is very fortunate to have a broad and diverse audit client base. In fact, our client base is almost a proxy for the New Zealand economy in terms of the diversity of size and range of entity types and sectors they operate in. This allows us to see a wide range of audit reports. From this snapshot, and through assisting other audit firms in New Zealand, we see a greater number of auditors qualifying their opinions in the NFP sector than we do in the for-profit sector.

Should we be worried that the financial transactions of our charities and NFP organisations are being called into question? To answer this question we need to understand the nature of the qualifications commonly requested.

Modified opinions

If the audit report is not "clean" or "unmodified" then the modification can be one of three main types:

1. **Adverse opinion**

The auditor disagrees with the treatment or disclosure of a matter in the financial statements that is so material (significant) and pervasive that the auditor believes the financial statements are misleading.

- → In short: We don't agree!
- → An adverse audit opinion is usually a very serious situation and readers of the financial statements should be concerned.

2. **Disclaimer of opinion**

The possible effects of a limitation of scope are both material and pervasive so that the auditor is unable to express an opinion i.e. where the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion.

- → In short: We can't tell so we can't give an opinion.
- → Like an adverse audit opinion, a disclaimer is also very serious and should put readers on notice.

3. **Qualified opinion**

The auditor concludes that either:

- Misstatements are material, but not pervasive, to the financial statements; or
- The possible effects on the financial statements of undetected misstatements (arising from a limitation of scope), if any, could be material but not pervasive.
- In short: Some of this is wrong, or we can't tell if some of it might be wrong.

Whether an audit report modification is serious or not will depend upon the specifics of it and the amounts involved. However there should be enough detail in the audit report for a reader to re-evaluate the reliance they place on the financial statements.

The concept of pervasiveness in the above modifications is important. If something is pervasive it is not confined to just specific elements of the financial statements; it represents a substantial proportion of the financial statements, or the disclosures would be fundamental to a reader's understanding of the financial statements.

Luckily for the readers of modified audit reports, the auditors are required to be very specific about what they are modifying. Hence it should be clear what type and hence how serious the modification is.

Emphasis of matter paragraphs

As the name suggests; emphasis of matter paragraphs can only emphasise matters that are already disclosed in the financial statements. An auditor will include an emphasis of matter paragraph when they issue an unmodified audit opinion, but also wish to highlight significant matters to the reader. These usually relate to inherent uncertainties about the outcome of future events and the impact on the financial statements.

For example if a NFP entity is relying on yet to be renegotiated funding to continue as a going concern then this uncertainty should be disclosed in the financial statements. The auditor is likely to consider this so important that it is worthy of an emphasis of matter paragraph.

Other matter paragraphs

Slightly less common, this is when an auditor adds another paragraph to their unmodified audit opinion because they believe it reveals a matter that has not been disclosed by the entity in their financial statements.

Summary

As you now know, audit report modifications vary and can significantly influence a reader's reliance on an audited set of financial statements. That said current audit standards are very helpful in that they require the auditor to be quite specific as to the scope and nature of their modifications to assist a reader's understanding.

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