

Solutions to Student Self Assessment Questions

Chapter 16

The auditors' report

Suggested solutions to self-assessment questions (available for students)

16.1 a) *False?*

The overriding concern of auditors is that the financial statements should give a true and fair view. If the auditors believe that a true and fair view can only be achieved by departing from the provisions contained in a specific SSAP or FRS or IFRSs, the alternative treatment should be applied. However, it should be appreciated that such circumstances are likely to be rare perhaps even extremely rare which is why we have appended a question-mark to our answer.

b) *True*

During their work, auditors are likely to come across many errors. Although even small errors, under certain circumstances, may be of interest to statutory auditors, their main concern is whether they result in the accounts being misleading or not giving a true and fair view. If they believe this to be the case and the client will not amend the accounts, there will be no alternative but to give a qualified/modified audit report.

c) *False*

Auditors also have a duty to state in their audit report if the information provided in the directors' report is consistent with the accounts (CA2006 s.496). For listed companies they also have certain duties as specified in the Listing Rules of the Financial Services Authority in respect of corporate governance. In respect of quoted companies the auditors are also expected to report on the auditable part of the directors' remuneration report and state whether that part has been prepared in accordance with the Companies Act 2006

In addition, ISA 720, The auditor's responsibilities relating to other information in documents containing audited financial statements requires then to read the other information in the annual report, such as, a chairman's statement to check there is no material inconsistency with the audited financial statements.

d) *True*

Auditors should always date the audit report and ensure that it is as close as possible to the date the accounts are signed by the directors. Clearly the date of the report should be the date upon which the auditors are satisfied that their audit fieldwork is complete.

e) *True*

ISA705 indicates that an 'except for' modified opinion is appropriate where the financial statements are materially misstated but the effect or potential effect of the misstatement is not pervasive. We are assuming here that if the effect on the financial statement does not result in the financial statements being seriously misstated or misleading then it is not pervasive. For further details on this you should refer back to the section above which outlines the matrix of audit qualifications. See Figure 16.2 on page 626

16.2 The auditors' unqualified audit report consists of the following sections:

Title and Addressee section – In this section the auditors will head the report 'Independent Auditor's Report' and state to whom the report is addressed. In the case of a company this will usually be the shareholders.

Scope or introductory paragraph – In this part the auditors will specify the pages in the annual report, on which they are reporting. These pages will encompass the financial

statements and accompanying notes. Instead of quoting the page numbers the auditors may instead list the statements that come within the scope of their audit. The auditors will also state the financial reporting framework that has been used in the preparation of the financial statements.

Responsibilities paragraph – In this part it is stated that the directors are responsible for the preparation of the financial statements and for ensuring that they show a true and fair view. They will usually indicate the page of the annual report where they include a more comprehensive statement of their responsibilities.

The auditors state that they are responsible for auditing the financial statements in accordance (for a UK Company) with the Companies Act 2006 and International Standards on Auditing. And that the latter require them to comply with the APB's Ethical Standards.

Scope Paragraph – In this paragraph the auditors will provide details of the nature of an audit with particular reference to the collecting of evidence to form an opinion and to give reasonable assurance that the financial statements are free from material misstatement whether caused by error or fraud. In addition the paragraph indicates that the auditors consider the appropriateness of the accounting policies and any significant estimates made by the directors.

As alternatives to this approach the auditors may include the statement elsewhere in the annual report or refer to an equivalent statement maintained on the APB's website.

Opinion paragraph – In this part of the audit report the auditors state that the financial statements give a true and fair view, that they are in conformance with the chosen accounting framework (UK GAAP or IFRSs) and comply with the Companies Act 2006. The opinion paragraph will also state that the financial statements have been prepared in accordance with the Companies Act 2006.

Opinion on other matters prescribed by the Companies Act 2006 – In this section the auditor states if the directors' report is consistent with the financial statements. They will also state if the audited part of the directors' remuneration report complies with the Companies Act 2006.

Matters on which we are required to report by exception – In this section the auditors report on matters such as whether the company has kept proper accounting records and if they have received all the explanations and information they required for the purposes of their audit

In the case of quoted companies they will also indicate that they have conducted a review of those parts of the corporate governance statement that are specified for their review.

In the final part of the audit report the auditors give the name and (office) address of the senior statutory auditor, the audit firm's name and the date on which they signed the audit report.

You may also have mentioned that the audit report might include a disclaimer of liability to third parties paragraph.

Gamston Burgers plc

- (i) This situation refers to an uncertainty where the auditors agree with the directors about the value of the tangible fixed assets. In addition, the auditors have obtained all the evidence they could have reasonably expected to be available. The facts indicate that this is a situation of uncertainty. The next stage is to determine the potential effect of the uncertainty. There are a number of factors the auditor will consider when deciding upon this, including, the

range of possible outcomes and their consequences. From the information given in the question, one possible outcome is that the tangible fixed assets would be worthless and this seems to suggest that it would be an important issue for users understanding of the financial statements. Support for this view is given in the question where it states that the effect of the tangible fixed assets being worthless would be material but that the financial statements would not be misleading, that is, they would still give a true and fair view. It is likely the auditors might want to include an explanatory emphasis of matter paragraph in their audit opinion. This paragraph would preferably be situated just after the opinion paragraph and it would describe the uncertainty and also, where possible, quantify the possible effect. The paragraph would state that the opinion is not modified in respect of the uncertainty.

The management of the company might argue that although the potential effect of the uncertainty is a material matter since its occurrence will not result in the financial statement being misleading then it is not an item that is of such importance that it is fundamental to users understanding of the financial statements. Since the nature of the item does not fit very with the type of matters that would be reported in an 'other Matter' paragraph management might argue there is no need for any reference to it in the audit report

- (ii) This example differs from the previous situation in that the auditors believe that the branch will have to close and that the tangible assets will be worthless. If the company were to include, as the question seems to indicate, the tangible fixed assets at a value of £710,000 then this would be a situation where the auditors disagree with the treatment adopted by the company. Where the auditors disagree they can issue one of two types of modified opinion; an except for or an adverse opinion. An adverse opinion would only be issued when the disagreement is both material and pervasive. Since the question indicates the effect would be material but that the financial statements would not be misleading then it does not appear to be a pervasive matter. Thus, it would seem appropriate that an except for opinion would not be the appropriate modification. The opinion paragraph would be headed "Qualified opinion on Financial Statements arising from disagreement about accounting treatment." In the except for opinion the auditors' opinion paragraph would include details of the disagreement, and quantification of the effects. The detail would state that in their opinion one of the company's branches tangible fixed assets are likely to be worthless and that the company should have made a provision of £710,000. The opinion would conclude with a paragraph stating "Except for the financial effect of not making this provision

Note: In the latest version of model audit reports contained in APB Bulletin 2010/2, Compendium of Illustrative Auditor's Reports on United Kingdom private Sector Financial Statement for periods ended on or after 15 December 2010, the opinion section would simply be headed 'Qualified opinion on financial statements'. The details of the disagreement would be contained in a separate paragraph titled 'Basis for qualified opinion on financial statements' and included just before the opinion paragraph.

- (iii) In this example the auditors have not been able to collect all the evidence they require to reach an opinion on the company's sales figure. In addition, we are told that where the uncertainty relates to all the company's sales then it could result in the financial statements as a whole being misleading. If this is taken as indicating that the extent of the financial effect of the uncertainty is so material and pervasive that the auditors are unable to express an opinion, they should issue a 'disclaimer' opinion. In the basis of opinion section of the audit report the auditors would explain why and in respect of what account items they were not able to collect all the evidence they consider necessary. The opinion section would be headed "Opinion: disclaimer on view given by financial statements." The

auditors in the opinion section of the audit report would state why they are unable to form an opinion on the financial statements, that is, because of the possible effects of the limitations of the evidence that is available. The paragraph will also state that the limitation relates to the company's cash takings and stock. It is likely that the paragraph would conclude with a statement by the auditors on the following lines:

In respect solely of the limitation on our work relating to cash sales:

"We have not obtained all the information and explanations that we considered necessary for the purpose of our audit; and we were unable to determine whether proper accounting records had been maintained."

Note: As with (ii) the latest APB Bulletin 2010/2 makes similar changes, abbreviating the title of the opinion section and including a separate paragraph titled 'Basis for disclaimer on financial statements' situated just before the opinion paragraph.

- (iv) This example is similar to the above except that the uncertainty only relates to the sale of certain items comprising 10% of the company's sales. The question states that the uncertainty would have a material effect on the financial statements but that it would not result in them being misleading. We can take it from this that the effect would not be pervasive. Thus, the auditor can form an opinion on the financial statements and therefore the appropriate qualification would be an except for qualification. In the opinion section of the audit report the auditors would explain that they were not able to obtain all the evidence necessary in respect of £XXX of the company's sales and that there was no other tests they could perform to provide the necessary evidence. The opinion paragraph would be headed "Qualified opinion arising from limitation in audit scope." In the opinion paragraph it would also be stated that except for adjustments that might be required in respect of the company's cash takings and stock because of the insufficiency of evidence the financial statements give a true and fair view. It is likely that the paragraph would conclude with a statement by the auditors on the following lines:

In respect solely of the limitation on our work relating to cash sales:

"We have not obtained all the information and explanations that we consider necessary for the purpose of our audit; and we were unable to determine whether proper accounting records had been maintained"

Note: As with (ii) and (iii) the latest APB Bulletin 2010/2 has introduced slight changes to the format of this type of 'except for' opinion similar to those indicated above.

- 16.3 (a) Whether or not you believe it is useful to include a scope paragraph with some details of the auditors' responsibilities depends upon whether you think there is confusion or little understanding of the nature of the auditors' role and responsibilities. Research in the area suggests there is some confusion over the auditors' responsibilities. Based on this research including details in the auditors' report would seem useful in helping to reduce the misunderstandings. Informing users in the audit report that the auditors' work involves estimates helps to convey the message that the audit process is subjective and that the audit report is not a guarantee. This and other text included in the scope paragraph may reduce expectations users have about what they expect from the auditors. It may be argued that the effectiveness in reducing any misunderstanding is dependent on users of the financial statements actually reading the audit report. If the audit report is not read thoroughly by users, it is unlikely that its wording will have any effect on users' perceptions of auditors' responsibilities. Finally, we suggest that including information about the nature of the audit, however limited the

description may be, is not likely to be detrimental to users, so that, even if any benefits are marginal, such information should be included in the audit report.

- (b) The main merit of the short form audit report is that because of its succinctness it is more likely to be read by users. Its very brevity may, it is argued, also mean that there is less opportunity for misunderstanding its content. In other words if you don't say very much, there will be fewer issues that might cause users confusion or misunderstanding. Of course, if you take this to its extreme it would imply that misunderstanding would be eliminated if the auditors said nothing. Since this is not the case it would appear that the amount of misunderstanding is likely to be dependent on the length of the audit report. It will also be affected by what is reported and the nature of the wording used.

The merit of the extended audit report is that it gives the opportunity to auditors to explain matters and issues in more detail and hence, perhaps, reduce misunderstanding and improve the usefulness of the audit report. If the above seems rather contradictory do not be alarmed. At various stages when the audit profession considered changing the audit report in the 1940s and 1970s many auditors argued that the short form audit report should be retained because it was more useful and less likely to lead to misunderstanding than an extended audit report. When, however, APB advocated an extended audit report one of the arguments they used was that it would be more useful and reduce users misunderstanding about the auditors' responsibilities and the nature of an audit. It would thus seem that even the audit profession and its members are slightly confused about the merits of the two types of audit report. A major criticism of the present extended audit report is while it gives details of the auditors' responsibilities specific details about any findings arising from the audit are limited and thus the audit report is not as informative as it might be.

- (c) The arguments, in brief, for and against auditors reporting on the effectiveness of company's internal control system are as follows:

Arguments for:

Auditors document and evaluate internal control systems as part of their audit work and therefore reporting on them would seem a logical and reasonable end product of their investigation. The effectiveness of internal control systems may provide clues as to the value the directors place on appropriate systems to safeguard the company's assets, control the business and so on. Thus, indirectly, any report may provide information about directors' abilities and integrity. A number of recent scandals, for instance, Barings Bank and Enron, have highlighted the implications of deficiencies in internal control.

Overall, it may be argued that reporting on the effectiveness of internal controls provides useful information to users. In the United States the requirement that auditors report on the effectiveness of internal control systems has caused considerable controversy because of problems related to its implementation and its cost.

Arguments against:

If the auditors were to report that the internal controls were poor this might lead to conflict with the directors and sour any personal relationship they have built up. In response it may be argued that the auditors are there to look after the shareholders interests and not those of the directors. It might be argued that the assessment of internal control is rather subjective and that the auditors would prefer not to report on something that is open to interpretation and dispute. If a company went into bankruptcy and it became evident that weaknesses in its internal control existed and previously the auditors had reported favourably on its system of internal control, this might lead to the auditors being sued for negligence. Thus, auditors may prefer not to report on internal controls because it might increase the likelihood of them being sued.

It might also be argued that because of its complexity reporting on internal control systems cannot be reduced to a simple standardised report. Thus any report would have to be complex and contain a substantial amount of information, explanation and technical terms. Following from this, it may be argued that such reports might lead to misinterpretation and misunderstanding on the part of readers of the audit report.

Finally, in the question we have left open what is meant by a company's systems of internal control. Normally auditors are mainly concerned with a company's financial system of internal control. If, however, we take it in its widest sense, this would require auditors to investigate aspects of internal control that they do not normally consider in depth or may not even have the expertise to evaluate.

- (d) Before answering this question it is useful to review the responsibilities of auditors in respect of corporate governance. As we mentioned above they are required to review the company's statement of corporate governance as it relates to certain Code provisions. It is likely that they will state in the audit report their responsibilities in respect of corporate governance. Where the Code has not been complied with, they should, identify if the company has stated it has not complied with a certain provision or provisions and determine if the directors have given adequate reasons for not complying. If these are satisfactory then the auditor need not mention the non-compliance. If, however, the auditors do not consider there is proper disclosure of the departure from a provision of the code which comes within their review they should disclose this in an 'other matter' paragraph.

The limited responsibilities of auditors would suggest that they play a relatively minor role in corporate governance, the major role being taken by the directors of a company. Whilst their specific responsibilities in respect of companies' statements on corporate governance may suggest that this is a reasonable conclusion, one might argue that their role is a more subtle one and that auditors do play an important 'behind the scenes' role in ensuring good corporate governance conduct by the directors. Other more strident critics have suggested that even the directors' responsibilities in respect of corporate governance have been so diluted that they are not very useful in the move towards greater corporate governance. If one holds this view then it is likely that the auditors' responsibilities would likewise be viewed as being not very onerous or useful.