ICAEW KNOW-HOW

AUDIT AND ASSURANCE FACULTY

PREPARING AN ADVERSE OPINION AUDIT REPORT

GUIDE

January 2019

Audit and Assurance Faculty Helpsheets are now known as ‘Guides’. This Guide was last updated in January 2019 and is based on the relevant laws and regulations that apply as at 1 January 2019.

Introduction

This Guide is designed to explain the main changes that are needed to the audit report when an auditor considers it necessary to issue an adverse opinion on the financial statements due to a material and pervasive misstatement in the financial statements. This assumes that aside from the matter giving rise to the adverse opinion, the auditor has obtained all other necessary evidence to support the opinion.

The example wording in this Guide has been adapted from the examples in the Appendix to ISA (UK) 705 and updated for UK legal and regulatory requirements. In this example, primarily based on illustration 2, while consolidated financial statements have been prepared, one subsidiary has not been included in that consolidation and the effect of this is considered material and pervasive to the consolidated financial statements. The effects of the misstatement on the consolidated financial statements have not been determined because it was not practicable to do so.

While the Guide comments on specific areas impacted by the adverse opinion for consolidated financial statements and the requirements for listed entities, Public Interest Entities as defined by the EU Regulation and entities applying the UK Corporate Governance Code, it does not deal with all of the changes that would be required.

Appendix 1 also gives details of the impact of the adverse opinion on subsequent years’ audit reports.

Pervasive changes to the audit report

There are numerous significant changes to the audit report and these have been set out below.

Addressee of the report

The addressee of the report is unchanged.

Adverse opinion

The opinion section is required to be headed up “Adverse opinion”.

Even though there is an adverse opinion, it is important that the titles of the primary statements precisely match those used by the entity.

The section still needs to reflect whether the financial reporting framework is either UK GAAP (including either FRS 101 or 102) or IFRSs.

The most important change is the wording of the adverse opinion itself to make clear that the auditor does not believe the financial statements give a true and fair view. In this example, it has been presumed that while there is an adverse opinion on the group financial statements, the parent company only financial statements are qualified only as the parent company only financial statements cannot say they have complied with IFRSs / UK GAAP and the Companies Act 2006.

In the example below, it is presumed that there is a combined audit report for the group and parent company. However, the auditor may instead choose to prepare separately an adverse opinion for the group and a qualified opinion for the parent company.

Adverse o~~O~~pinion

We have audited the financial statements of [ABC Limited] (the 'parent company') and its subsidiaries (the 'group') for the year ended [date] which comprise [specify the titles of the primary statements] and notes to the financial statements, including a summary of significant accounting policies. The financial reporting framework that has been applied in their preparation is applicable law and [United Kingdom Accounting Standards, including [Financial Reporting Standard 101 Reduced Disclosure Framework / Financial Reporting Standard 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland] (United Kingdom Generally Accepted Accounting Practice) / International Financial Reporting Standards (IFRSs) as adopted by the European Union].

In our opinion, because of the significance of the matter described in the basis for adverse opinion section of our report, the group financial statements:

- do not give a true and fair view of the state of the group's affairs as at [date] and of the group's [profit/loss] for the year then ended;
- have not been properly prepared in accordance with [United Kingdom Generally Accepted Accounting Practice / IFRSs as adopted by the European Union]; and
- have not been prepared in accordance with the requirements of the Companies Act 2006.

In our opinion, except for the effects of the matter described in the basis for adverse opinion section of our report, the parent company financial statements:

give a true and fair view of the state of the parent company's affairs as at [date] [and of ~~its~~ the parent company's [profit/loss] for the year then ended]*;

have been properly prepared in accordance with [United Kingdom Generally Accepted Accounting Practice / IFRSs as adopted by the European Union]; and

have been prepared in accordance with the requirements of the Companies Act 2006.

* Include where the section 408 exemption has not been taken from preparing the parent company's own profit and loss account.

Basis for adverse opinion

The heading needs to be revised from "Basis for opinion" to read "Basis for adverse opinion".

This section needs to explain the specific reasons for the adverse opinion and make clear why the effect on the financial statements is both material and pervasive. This also provides useful information to users in understanding why the auditor has issued an adverse opinion and may further guard against inappropriate reliance on those financial statements.

In addition, an adverse opinion does not mean that the auditor can ignore any additional identified matters that would have otherwise required a modification of the auditor's opinion – for example if there is a matter that the auditor knows is materially misstated, this must also be reported in addition to the reasons for the adverse opinion.

If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including quantitative disclosures), the auditor is required to include in the basis for adverse opinion section a description and quantification of the financial effects of the misstatement, unless impracticable. If it is not practicable to quantify the financial effects, the auditor is required to state this.

An example of suggested wording is included in Illustration 2 of ISA (UK) 705 and is reproduced below, but would naturally have to be adapted to the specific circumstances of the entity.

> As explained in note X, the group has not consolidated subsidiary XYZ that the group acquired during 20X1 because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under [IFRSs / FRS 102], the parent company should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had XYZ been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined. Our opinion on the parent company's financial statements is also qualified for this matter as the failure to consolidate all subsidiaries is a departure from the requirements of [IFRSs / FRS 102] and the Companies Act 2006.
>
> 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 group and the parent 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 on the group financial statements and qualified opinion on the parent company financial statements.

Key audit matters

ISA (UK) 705 makes clear that for entities within the scope of ISA (UK) 701, the auditor is still required to include a key audit matters section even when issuing an adverse opinion.

The matter giving rise to the adverse opinion is by its nature a key audit matter. However, this is not described in detail as part of the key audit matters section and the auditor needs to refer in that section to the basis for adverse opinion section of the audit report.

Assuming there are other key audit matters, the following wording is used:

> **Key audit matters**
>
> …
>
> In addition to the matter described in the basis for adverse opinion section, we have determined the matters described below to be the key audit matters to be communicated in our report.
>
> …

If there are no other key audit matters, the following wording is used:

> **Key audit matters**
>
> Except for the matter described in the basis for adverse opinion section, we have determined that there are no key audit matters to be communicated in our report.

Conclusions relating to going concern

As the auditor has identified an issue that is so pervasive that they have concluded that the financial statements do not give a true and fair view, it may not be appropriate for the auditor to conclude on whether the use of the going concern basis of accounting is appropriate. In particular, the reason for the adverse opinion may directly relate to the disagreement over the use of the going concern basis of accounting. In such instances, the section is not required.

There may, however, be circumstances in which the auditor may still feel it appropriate to conclude on whether the use of the going concern basis of accounting is appropriate.

In this specific example (non-consolidation of a subsidiary) the adverse opinion only relates to the group, so there may be no issue in relation to the parent company's use of the going concern basis of accounting for its own parent company only financial statements. In addition, the auditor may still be able to be satisfied that use of the going concern basis of accounting is appropriate for the consolidated financial statements notwithstanding the adverse opinion.

Where group and parent company financial statements are prepared, the impact on each needs to be considered. If the reason for the adverse opinion does not significantly impact the use of the going concern basis of accounting for both the group and parent company, the going concern section can refer to both. Where the reason for the adverse opinion does not significantly impact the use of the going concern basis of accounting for the parent company, but does impact the group, the section refers only to the parent company. Where the reason for the adverse opinion significantly impacts both the group and parent company's use of the going concern basis of accounting, the section is not required.

Other information

In circumstances when an adverse opinion is issued, consideration may be given as to whether the other information is also materially misstated for the same matter as, or a related matter to, the matter giving rise to the adverse opinion on the financial statements.

> The other information comprises the information included in the annual report, other than the financial statements and our auditor's report thereon. The directors are responsible for the other information.
>
> Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in our report, we do not express any form of assurance conclusion thereon.
>
> In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact.
>
> ~~We have nothing to report in this regard.~~ As described in the basis for adverse opinion section of our report, the group financial statements have not consolidated subsidiary XYZ and this investment is accounted for on a cost basis. We have concluded that the other information is materially misstated for the same reason with respect to the amounts or other items in the annual report affected by the failure to consolidate this subsidiary.

Opinions on other matters prescribed by the Companies Act 2006

Given that there is an adverse opinion, it is unlikely that the auditor would be able to report on whether the strategic report in particular has been prepared in accordance with the requirements of the Companies Act 2006. Assuming the information is consistent with the financial statements, the auditor may conclude that, for example, the strategic report does not provide a fair review of the financial position and performance. As the reason for this is closely related to the matter described in the basis for adverse opinion section, it may be possible to add a separate sentence in that section rather than create a separate section called "Basis for [adverse/qualified] opinion on other matters prescribed by the Companies Act 2006":

> As explained in note X, the group has not consolidated subsidiary XYZ that the group acquired during 20X1 because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore

accounted for on a cost basis. Under [IFRSs / FRS 102], the parent company should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had XYZ been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined. Our opinion on the parent company financial statements is also qualified for this matter as the failure to consolidate all subsidiaries is a departure from the requirements of [IFRSs / FRS 102] and the Companies Act 2006. In addition, the directors' report and strategic report do not consider the effects of the failure to consolidate this subsidiary.

Assuming that there are no further issues with either the strategic report or directors' report, the auditor may conclude that given the nature of the modification, there is either no impact to the directors' report or the impact is more limited. The impact is likely to be more pervasive to the strategic report. Where the auditor concludes that there is limited impact to the directors' report, the wording is amended as follows.

Because of the significance of the matter described in the basis for adverse opinion section of our report, Iin our opinion, based on the work undertaken in the course of the audit:

- ~~the information given in the strategic report and the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and~~
- the strategic report ~~and the directors' report have~~ has not been prepared in accordance with applicable legal requirements.

Except for the effects of the matters described in the basis for adverse opinion section of our report, in our opinion, based on the work undertaken in the course of the audit:

- the information given in the strategic report and the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the directors' report has been prepared in accordance with applicable legal requirements.

Where only a directors' report has been prepared for a small company that is preparing consolidated financial statements, as the requirements for the contents of the directors' report are more limited, the auditor may be able to issue an "except for" opinion:

Except for the effects of the matters described in the basis for adverse opinion section of our report, iIn our opinion, based on the work undertaken in the course of the audit:

- the information given in the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the directors' report has been prepared in accordance with applicable legal requirements.

Matters on which the auditor is required to report by exception

If, as in this example, the strategic report is materially misstated in respect of the failure to consolidate the subsidiary, the auditor needs to modify the following reporting. It may be possible to state that there are no material misstatements in the directors' report but in this example, it is assumed that this also results in a material misstatement in the directors' report.

As a result of the matters described in the basis for adverse opinion section of our report, iIn the light of the knowledge and understanding of the group and parent company and their environment obtained in the course of the audit, we have ~~not~~ identified material misstatements in the strategic report and ~~or~~ the directors' report.

…

The auditor also needs to consider whether any of the other matters reported by exception would be impacted. In particular, the auditor may want to consider whether the auditor has received all the information and explanations they require for the audit. A failure to disclose the non-consolidation of the subsidiary by itself may not lead to a modification, but if the auditor is unable to assess the impact of non-disclosure, that may be considered a failure to obtain all of the necessary information and explanations.

Responsibilities of directors

No changes are needed.

Auditor’s responsibilities for the audit of the financial statements

No changes are needed.

Use of the audit report

No changes are needed to the guidance provided in Technical Release 01/03AAF (Revised), The Audit Report and Auditors’ Duty of Care to Third Parties.

Signature on the audit report

The same requirements apply as if the audit report were unmodified.

Appendix 1 – impact on the opinion in subsequent years

ISA (UK) 710 states that if the auditor's report on the prior period as previously issued included a modified opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the basis for modified opinion section, the auditor shall either:

a) *Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material.*

   This will be the case where in the subsequent year the same misstatement is repeated. An example of the disclosure in the subsequent year is as follows:

> As explained in note X, the group has not consolidated subsidiary XYZ that the group acquired during 20X1 because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under IFRSs, the parent company should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had XYZ been consolidated, many elements in the accompanying consolidated financial statements for the year ended [date] 20X2 and year ended [date] 20X1 would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined. Our opinion on the parent company's financial statements is also qualified for this matter as the failure to consolidate all subsidiaries is a departure from the requirements of [IFRSs / FRS 102] and the Companies Act 2006.
>
> …

   The adverse opinion will recur for as long as the misstatement continues in both the current and prior years assuming that it is of the same scale and pervasive to the financial statements.

b) *In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.*

   In practice, this is unlikely to apply for an adverse opinion. It is more likely that the adverse opinion will either have been resolved in some way (such as retrospective restatement of the prior year figures) or the adverse opinion would continue. If, however, the directors produced proper consolidated accounts in a subsequent year, but failed to restate the comparatives, then there would be a modification in respect of the comparability of current and corresponding figures.

> As explained in note X, the group has not consolidated subsidiary XYZ that the group acquired during 20X1 because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under IFRSs, the company should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had XYZ been consolidated, many elements in the accompanying consolidated financial statements for the year ended [date] 20X1 would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate in 20X1 have not been determined. In addition, the parent company financial statements in 20X1 failed to comply with the requirements of [IFRSs / FRS 102] and the Companies Act 2006 by failing to consolidate all subsidiaries. Our audit opinions on the group and parent company financial statements for the period ended [date] 20X1 was modified accordingly. Our opinion on the current period's financial statements is also modified because of the possible effect of this matter on the comparability of the current period's figures and the corresponding figures.
>
> …

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