ICAEW KNOW-HOW
AUDIT AND ASSURANCE FACULTY

PREPARING A QUALIFIED AUDIT REPORT - DISAGREEMENT (RELATED PARTIES EXAMPLE)

GUIDE

14 June 2018

Audit and Assurance Faculty Helpsheets are now known as 'Guides'. This Guide was last updated in June 2018 and is based on the relevant laws and regulations that apply as at 1 June 2018.

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 a modified opinion on the financial statements due to a material misstatement in the financial statements. The example chosen to illustrate the amendments needed to a modified opinion is where there is a material deficiency in the information relating to related party transactions that is required to be disclosed by the financial reporting framework.

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.

For the purposes of this Guide, it has been presumed that the company is not required nor has chosen to prepare group financial statements. While the Guide comments on specific areas impacted by the qualification 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 for those entities.

Appendix 1 also gives details of the impact of the qualification on subsequent years' audit reports.

Pervasive changes to the audit report

There are a limited number of changes to the audit report and these have been set out below.

Addressee of the report

The addressee of the report is unchanged.

Qualified opinion

The opinion section is required to be headed up "Qualified opinion".

Even though there is a qualified 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 IFRS.

The most important change is the wording of the qualified opinion itself to make clear that except for the effects of the matter with which the auditor disagrees, the auditor is able to provide an unmodified opinion on the financial statements.

Qualified ~~o~~Opinion

We have audited the financial statements of [XYZ Limited] (the 'company') 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, except for the effects of the matter described in the basis for qualified opinion section, the financial statements:

- give a true and fair view of the state of the company's affairs as at [date] and of its [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.

Basis for qualified opinion

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

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

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 qualified 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.

If there is a material misstatement of the financial statements that relates to qualitative disclosures, the auditor is required to include in the basis for qualified opinion section an explanation of how the disclosures are misstated.

If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor is required to:

a) Discuss the non-disclosure with those charged with governance;

b) Describe in the basis for qualified opinion section the nature of the omitted information; and

c) Unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

In relation to matters of non-disclosure, as ISA (UK) 705 requires the auditor to disclose the matter in the auditor's report, this often encourages the entity to disclose the matter in the financial statements anyway and therefore means that a qualification may no longer be required.

An example of suggested wording where the directors refuse to amend the financial statements is included below, but would naturally have to be adapted to the specific circumstances of the entity.

The notes to the financial statements do not disclose that one of the company's directors, John Smith, controls ABC Limited, from which the company purchased goods and services during the year of £x. Such disclosure is required by [FRS 102 / IFRSs as adopted by the European Union].

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.

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 a qualified opinion.

The matter giving rise to the qualification 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 qualified opinion section of the audit report.

Key audit matters

…

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

…

Conclusions relating to going concern

No changes are needed, assuming the qualification does not relate to going concern.

Other information

In circumstances when the auditor's opinion is qualified, 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 qualified 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 qualified opinion section of our report, our audit opinion is qualified for non-disclosure of related party transactions. Information on related party transactions included in the [strategic report] also omits this information and accordingly we have concluded that the other information is materially misstated for the same reason.

Opinions on other matters prescribed by the Companies Act 2006

The auditor needs to consider whether the matter leading to the qualification also impacts the opinion on other matters prescribed by the Companies Act. If, for example, the strategic report is also materially misstated in respect of the non-disclosure of related party transactions, such as by disclosing all other related party transactions, then while it may be consistent with the financial statements, the strategic report may not have been prepared in accordance with the applicable legal requirements. The auditor may therefore need to qualify this section as well. As this is closely related to the matter described in the basis for qualified opinion section, it may be possible to add a separate sentence in that section rather than create a separate section on called “Basis for qualified opinion on other matters prescribed by the Companies Act”:

> The notes to the financial statements do not disclose that one of the company’s directors, John Smith, controls ABC Limited, from which the company purchased goods and services during the year of £x. Such disclosure is required by [FRS 102 / IFRSs as adopted by the European Union]. In addition, information on related party transactions included in the [strategic report] also omits this disclosure.

The qualified opinion could then also refer to that section:

> Except for the matter described in the basis for qualified opinion section of our report, i~~I~~n 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 been prepared in accordance with applicable legal requirements.

Matters on which the auditor is required to report by exception

If the strategic report is materially misstated in respect of the non-disclosure of related party transactions, the auditor needs to qualify the following reporting relating to material misstatements in the strategic report.

> Except for the matter described in the basis for qualified opinion section of our report, i~~I~~n the light of the knowledge and understanding of the company and its environment obtained in the course of the audit, we have not identified material misstatements in the strategic report or the directors’ report.
>
> …

For this example, it is unlikely that any of the other matters reported by exception would be impacted, but the auditor always needs to consider if any of them are relevant.

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. Assuming that the report is for a company, it is required to be signed by the senior statutory auditor, for and on behalf of the audit firm:

> [Signature]
>
> John Smith (Senior Statutory Auditor)
>
> For and on behalf of ABC LLP, Statutory Auditor
>
> [Address]
>
> [Date]

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 qualified 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 qualified 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 non-disclosure is repeated. An example of the disclosure in the subsequent year is as follows:

> The notes to the financial statements do not disclose that one of the company's directors, John Smith, controls ABC Limited, from which the company purchased goods and services during the year ended [date] 20X1 of £y and year ended [date] 20X0 of £x. Such disclosure is required by [FRS 102 / IFRSs as adopted by the European Union].
>
> …

   This opinion will recur for as long as there is non-disclosure in both the current and prior years.

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.*

   This is likely to be the case in in the subsequent year following the non-disclosure assuming that there is no similar non-disclosure for that year. This is because the prior year related party disclosure will not be comparable with the current year's disclosure. An example of the disclosure in the basis for qualified opinion section for the subsequent year is as follows:

> The notes to the financial statements do not disclose that one of the company's directors, John Smith, controls ABC Limited, from which the company purchased goods and services during the year ended [date] 20X0 of £x. Such disclosure is required by [FRS 102 / IFRSs as adopted by the European Union]. Our audit opinion on the financial statements for the year ended [date] 20X0 was modified accordingly. Our opinion on the current period's financial statements is also modified because of the effect of this matter on the comparability of the current period's figures and the corresponding figures.
>
> …

   In addition, the qualified opinion section will need to make clear that the qualification only relates to the corresponding figures:

> **Qualified opinion**
>
> …
>
> In our opinion, except for the effects on the corresponding figures of the matter described in the basis for qualified opinion paragraph, the financial statements:
>
> • …

   In the third year, the qualification is unlikely to carry forward as the non-disclosure will not affect either year.

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