

Modifications to Auditor’s Opinion and Auditor’s Report (Relevant to AAT Examination Paper 8: Principles of Auditing and Management Information Systems)

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Background

Following the redraft of the International Standards on Auditing and the International Standard on Quality Control by the International Auditing and Assurance Standards Board to improve the understandability of auditing standards, the Hong Kong Institute of Certified Public Accountants has issued Hong Kong Clarified Pronouncements on Auditing and these clarified pronouncements are effective for audits of financial statements for periods beginning on or after 15 December 2009.

Superseded Hong Kong Standards on Auditing

Readers are reminded that the following two Hong Kong Standards on Auditing (HKSA) are no longer effective after 14 December 2009: HKSA 700 “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements” and HKSA 701 “Modifications to the Independent Auditor’s Report”.

Prevailing Hong Kong Standards on Auditing

To replace the two superseded HKSA, three new HKSA have been issued. These are HKSA 700 “Forming an Opinion and Reporting on Financial Statements”, HKSA 705 “Modifications to the Opinion in the Independent Auditor’s Report”, and HKSA 706 “Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report”. In this article, we focus on the new HKSA 705 and HKSA 706. Structurally, the new auditing standards introduce the following sections: (i) objectives; (ii) definitions, and (iii) application and other explanatory material. Furthermore, they include changes in circumstances that would lead to a modification of the auditor’s opinion.

Clarified pronouncements

Superseded HKSA	Guidance on	Prevailing HKSA		
		700	705	706
700	Content and structure of an unmodified audit report	X		
701	Matters that do <u>not</u> affect auditor’s opinion: - Emphasis of matter			X
	Matters that do affect auditor’s opinion: - Qualified opinion - Disclaimer of opinion - Adverse opinion		X X X	
	n.a.	Matters that do <u>not</u> affect auditor’s opinion - Other matters		

The new HKSA 705 aims to provide guidance solely on modifications to the auditor’s opinion and to replace the superseded HKSA 701 which provided guidance on both modifications to the auditor’s report and the auditor’s opinion. In practice, there may be circumstances in which the auditor considers it necessary to draw users’ attention to a matter presented or disclosed in the financial statements that is of such importance and is fundamental to users’ understanding of the financial statements. However, the matter does not affect the auditor’s opinion, i.e. no modification to the auditor’s opinion is required. Both the new HKSA 700 and HKSA 705 do not cover such circumstances, and hence HKSA 706 is introduced to deal with (i) emphasis of matter, and (ii) other matters. Its content is summarized as follows:

HKSA 706: Modification to the auditor's report

	“Emphasis of matter” paragraph	“Other matters” paragraph
What sort of matters do they relate to?	Appropriately presented or disclosed in the financial statements.	Matters other than those presented or disclosed in the financial statements.
Why does the auditor want to draw the user's attention to these matters?	The matter is of such importance that it is fundamental to the user's understanding of the financial statements.	The matter is relevant to user's understanding of: (i) the audit; (ii) the auditor's responsibilities, or (iii) the auditor's report.
Does it affect the auditor's opinion?	No	No
What is the title of the paragraph?	Emphasis of Matter	Other Matters
Where should the paragraph be added in the auditor's report?	Immediately after the “Opinion” paragraph, but before the paragraph on any other reporting responsibilities, if any.	Immediately after the “Opinion” paragraph and any “Emphasis of matter” paragraph.
Under what circumstances this should be stated in the auditor's report?	<ul style="list-style-type: none"> • Uncertainty relating to the future outcome of exceptional litigation or regulatory action • Early application of a new accounting standard • A major catastrophe having a significant effect on the entity's financial position 	<ul style="list-style-type: none"> • To explain why the auditor cannot withdraw from the engagement • To explain the auditor's responsibilities other than the statutory audit • To explain that the auditor has issued a report on another set of financial statements prepared under another accounting framework • To state that the auditor's report is intended solely for the intended users and should not be distributed to or used by other parties
What are the conditions of usage of such a paragraph?	<ul style="list-style-type: none"> • Information shown here should not exceed what has been presented or disclosed in the financial statements; otherwise, this would imply that the matter has not been appropriately presented or disclosed • It is not a substitute for a modification to auditor's opinion or disclosure in the financial statements 	<ul style="list-style-type: none"> • Information that the auditor is prohibited from providing by law, regulation or other professional standards should not be included • Information that is required to be provided by management should not be included • May include report on other legal and regulatory requirements • May include communication with those charged with governance

HKSA 705: Modification to the auditor’s opinion

In the new HKSA 705, a pre-condition in determining which type of modification is required to the auditor’s opinion is whether the auditor is able to obtain sufficient appropriate audit evidence. Sufficiency is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor’s assessment of the risks of material misstatement and also by the quality of such audit evidence. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based.

The following table distinguishes which type of modification to the auditor’s opinion should be applied:

Types of modification to the auditor’s opinion	Superseded HKSA 701	Prevailing HKSA 705	
		Auditor is able to obtain sufficient appropriate audit evidence	Auditor is <u>unable</u> to obtain sufficient appropriate audit evidence
Qualified opinion	Expressed as being “ except for ” the effects of either: <ul style="list-style-type: none"> - a disagreement with management, or - a limitation on scope, but the effect is <u>not so material and pervasive</u> .	Expressed as being “ except for ”, as the auditor concludes that misstatements, individually or in the aggregate, are <u>material, but not pervasive</u> , to the financial statements.	Expressed as being “ except for ”, as the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be <u>material but not pervasive</u> .
Disclaimer of opinion	“ Do not express an opinion ” because the possible effect of a <u>limitation on scope</u> is so <u>material and pervasive</u> .	“ Do not express an opinion ” because the auditor concludes that it is not possible to form an opinion on the financial statements due to the <u>potential interaction of the uncertainties</u> and their possible <u>cumulative effect</u> on the financial statements.	“ Do not express an opinion ” because the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be <u>both material and pervasive</u> .
Adverse opinion	“ Do not give a true and fair view ” because the effect of a <u>disagreement</u> is so <u>material and pervasive</u> to the financial statements.	“ Do not give a true and fair view ” because the auditor concludes that misstatements, individually or in the aggregate, are <u>both material and pervasive</u> to the financial statements.	n.a.

Other than the word “material”, “pervasive” is used to describe the effects on the financial statements of misstatements. Pervasive effects on the financial statements are those that, in the auditor’s judgment:

- (i) are not confined to specific elements, accounts or items in the financial statements;
- (ii) if so confined, represent or could represent a substantial proportion of the financial statements; or
- (iii) in relation to disclosures, are fundamental to users’ understanding of the financial statements.

Types of modified opinions

The table below illustrates how the auditor’s judgment on the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affect the type of opinion to be expressed.

Nature of matter giving rise to the modification	Auditor’s judgment about the pervasiveness of the effects or possible effects on the financial statements	
	Material but not pervasive	Material and pervasive
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Common conceptual mistakes

Note that a qualified opinion is only one of three types of modified opinion. During the examination, candidates should state clearly whether the modified opinion is an adverse opinion, a disclaimer of opinion or a qualified opinion.

Some old text books used phrases such as “with the foregoing explanation” or “subject to” in the opinion paragraph; these are inappropriate and are not clear expression of the auditor’s opinion.