Beginner's Guide to Audit and Audit Reports

Audit

1. An **Audit** is an **ex post** review of the books of accounts, records of transactions and financial and other systems maintained by an entity, and of its financial statements.

2. An audit is carried out by independent professional accountants and aims to:
   - Provide assurance of accountability;
   - Give credibility to the financial statements and other management reports;
   - Identify weaknesses in internal controls and financial systems and make recommendation thereon.

Auditor's report

3. The **Auditor's report** is a formal opinion by either an internal auditor or an independent external auditor as a result of an internal or external audit performed on a legal entity or subdivision thereof (called an "auditee"). The report is provided to a "user" (such as an organisation or a government) as an assurance service in order for the user to make decisions based on the results of the audit.

4. This is considered an essential tool when reporting financial data; many users require financial information to be certified by a certified public accountant and/ or the State auditor, and this has become best market practice.

Auditor's report on financial statements

5. This auditor's report advises users on whether the auditee's financial statements have been prepared in accordance with a **stated set of accounting principles** (GAAP), whether they are free of material misstatement (e.g. free of important and significant errors), and whether they show a true and fair view of the operating results, financial position and cash flows of the auditee. The report is thus an assurance on whether the financial information presented by the auditee is materially trustworthy for making various decisions.

6. There are four different types of auditor reports issued, which are considered standard and mandatory in accordance with Generally Accepted Auditing Standards (GAAS). GAAS provide guidance on the objectives and general principle governing an audit of financial statements. Various GAAS frameworks exist, comprising a set of systematic guidelines used by auditors when conducting audits, ensuring the accuracy, consistency and verifiability of auditors' actions and reports. The principal frameworks recognised worldwide include the US GAAS and International Standards on Auditing ("ISA"). The auditing standards applied should be specified in the auditor's opinion.

Unqualified Opinion/ "Clean" opinion report

7. This is regarded by many as the equivalent of a "clean bill of health" to a patient. This type of report is issued when the organisation's financial condition, position, and operations are fairly presented in the accounts.

8. The first paragraph (the **introductory paragraph**) states the audit work performed and identifies the responsibilities of the auditor and the auditee in relation to the financial statements. The second paragraph (the **scope paragraph**) details the scope of audit work, provides a general description of the nature of the work, examples of procedures performed, and any limitations the audit faced based on the nature of the work. This

paragraph also states that the audit was performed in accordance with the GAAS of reference. The third paragraph (the **opinion paragraph**) states the auditor's opinion on the financial statements and whether they are in accordance with the accounting principles of reference (national/ international).

Qualified Opinion/ "Except for" Opinion

9. A **Qualified Opinion** is very similar to an unqualified or "clean opinion", but the report states that the financial statements are fairly presented with a certain exception which is otherwise misstated. The two types of situations which would cause an auditor to issue this opinion as follows:

- <u>Single deviation from GAAP</u> –at least one area of the financial statements does not conform to GAAP but this does not affect the rest of the financial statements from being fairly presented when taken as a whole. Examples of this include an organisation that did not correctly calculate the depreciation expense of its building. Even if this expense is considered material, since the rest of the financial statements do conform to GAAP, then the auditor qualifies the opinion by describing the depreciation misstatement in the report and continues to issue a clean opinion on the rest of the financial statements.
- <u>Scope of limitation</u> - this type of qualification occurs when the auditor could not audit one or more areas of the financial statements. Examples of this include an auditor not being able to observe and test an organisation's inventory of goods. The auditor states that the financial statements are fairly presented, with the exception of the inventory which could not be audited.

10. The wording of the qualified report is very similar to the Unqualified opinion, but an **explanatory paragraph** is added to explain the reasons for the qualification.

> "In our opinion, *except for the effects of the Organisation's incorrect determination of depreciation expense,* the financial statement referred to in the first paragraph presents fairly, in all material respects, the financial position of…………In our opinion, *except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to perform proper tests and procedures on the Organisation's inventory*, the financial statements referred to in the first paragraph presents fairly, in all material respects, the financial position of…"

Adverse Opinion report

11. An **Adverse Opinion** is issued when the auditor determines that the financial statements of an auditee are materially misstated and, when considered as a whole, do not conform to GAAP. It is considered the opposite of an unqualified or clean opinion, essentially stating that the information contained is materially incorrect, unreliable, and inaccurate in order to assess the auditee's financial position and results of operations. Investors and governments very rarely accept an auditee's financial statements if the auditor issues an adverse opinion, and usually request the auditee to correct the financial statements and obtain another audit report.

> "In our opinion, *because of the situations mentioned above* (in the explanatory paragraph), the financial statements referred to above *do not* present fairly, in all material respects, the financial position of…"

Disclaimer of Opinion report

12. A **Disclaimer of Opinion** is rarely used and is issued when the auditor could not form, and consequently refuses to present, an opinion on the financial statements. The auditor cannot complete the audit work due to various reasons and does not issue an opinion.

13. A disclaimer of opinion may be appropriate in the following circumstances:

- A lack of independence, or material conflict(s) of interest, exist between the auditor and the auditee;
- There are significant scope limitations, whether intentional or not, which hinder the auditor's work in obtaining evidence and performing procedures;
- There is a substantial doubt about the auditee's ability to continue as a going concern (see below).

14. Investors and governments typically reject an auditee's financial statements if the auditor disclaimed an opinion, and will request the auditee to correct the situations the auditor mentioned and obtain another audit report.

> We *were engaged to audit* the accompanying……….financial statements……… *The Organisation does not maintain adequate accounting records to provide sufficient information for the preparation of the basic financial statements.………*Because of the significance of the matters discussed in the preceding paragraphs, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion of the financial statements referred to in the first paragraph.

Going concern

15. Going concern is a term which means that an entity is foreseen to continue to operate indefinitely. If the auditee is not a going concern, it means that it is either dissolved, bankrupt, etc. Auditors are required to consider the going concern of an auditee before issuing a report. If the auditee is a going concern, the auditor does not modify the audit report. H9owever, if the auditee is not a going concern, or will not be a going concern in the near future, then the auditor is required to include an additional paragraph in the audit report explaining the situation, which is commonly referred to as the **going concern disclosure**, including the auditee's plan to correct the situation.

Other explanatory information and paragraphs

16. The auditor may add additional information to the report if it is deemed necessary without changing the overall opinion of the report. The most frequent paragraphs include:

- Limiting distribution of the report – in some occasions, the audit report is restricted to a specified user and the auditor includes this restriction in the report, such as a report for financial statements made in cash basis which are prepared for tax purposes only, financial statements for a wholly-owned subsidiary whose sole user of its financial statements is its parent organisation, etc.
- Additional or supplemental information – Certain auditees include additional and/or supplemental information with their financial statements which is not directly related to the financial statements. Examples include specific reporting requirements from financial institutions.