ICAEW KNOW-HOW
AUDIT AND ASSURANCE FACULTY

PREPARING AN AUDIT REPORT WITH A DISCLAIMER OF OPINION

GUIDE

Updated August 2021

This Guide was last updated in August 2021 and is based on the relevant laws and regulations that apply as at 1 August 2021.

Introduction

This Guide is designed to explain the main changes that are needed to the audit report when an auditor considers it necessary to disclaim the opinion on the financial statements as a whole.

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.

Where the reason for the possible disclaimer of opinion is due to a management-imposed limitation that could be both material and pervasive, ISA (UK) 705 paragraph 13(b) requires the auditor to withdraw from the audit, where practicable and possible under applicable laws or regulations. Only where this is not practicable nor possible, does the auditor issue a disclaimer of opinion on financial statements.

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 disclaimer of opinion for listed, Public Interest Entities and entities applying the UK Corporate Governance Code, it does not deal with all of the changes that would be required for those entities.

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.

Disclaimer of opinion

The opinion section is required to be headed up ‘Disclaimer of opinion’.

The paragraph specifying the titles of the primary statements refers to the auditor being ‘engaged to audit the financial statements’ as the auditor did not complete the audit and even though there is a disclaimer of 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 disclaimer itself to make clear that the auditor is unable to provide an opinion on the financial statements.

<u>Disclaimer of ~~o~~Opinion</u>

We <u>were engaged to</u> ~~have~~ audit~~ed~~ 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 accounting standards in conformity with the requirements of the Companies Act 2006[1]/ United Kingdom adopted International Financial Reporting Standards (IFRSs)[2]].

~~In our opinion, the financial statements:~~

- ~~give a true and fair view of the state of the group's and of the parent company's affairs as at [date] and of the group's [profit/loss] for the year then ended;~~
- ~~have been properly prepared in accordance with [United Kingdom Generally Accepted Accounting Practice / international accounting standards in conformity with the requirements of the Companies Act 2006 / United Kingdom adopted International Financial Reporting Standards (IFRSs)];~~
- ~~have been prepared in accordance with the requirements of the Companies Act 2006.~~

<u>We do not express an opinion on the accompanying financial statements of the company. Because of the significance of the matter described in the basis for disclaimer of opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.</u>

Basis for disclaimer of opinion

The heading needs to be revised from 'Basis of opinion' to read 'Basis for disclaimer of opinion'.

This section needs to explain the specific reasons for the disclaimer of opinion and make clear why the possible effects on the financial statements could be both material and pervasive. This also provides useful information to users in understanding why the auditor has disclaimed the opinion and may further guard against inappropriate reliance on those financial statements.

In addition, a disclaimer of 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 disclaimer of opinion.

This section, however, does not include the typical references to performing the audit in accordance with ISAs (UK) and ethical requirements, as those matters are instead reported on in the section detailing the auditor's responsibilities.

An example of suggested wording is included in Illustration 5 of ISA (UK) 705 and is reproduced below, but would naturally have to be adapted to the specific circumstances of the entity.

We were not appointed as auditors of the company until after 31 December 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at 31 December 20X0 and 20X1, which are stated in the statements of financial position at £x and £y, respectively. In addition, the introduction of a new computerised accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the statement of financial position at a total amount of £z as at 31

[1] For periods commencing before 1 January 2021.
[2] For periods commencing on or after 1 January 2021.

December 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the statement of comprehensive income, statement of changes in equity and statement of cash flows.

Key audit matters

ISA (UK) 705 makes clear that for audits of Public Interest Entities as defined by the EU Regulation the auditor is still required by law or regulation to include a key audit matters section even when issuing a disclaimer of opinion. For other entities that are listed, for example AIM companies, ISA (UK) 705 makes clear that the auditor should not report on key audit matters when disclaiming an opinion.

Conclusions relating to going concern

As the auditor has identified an issue that is so pervasive and is therefore unable to conclude on the financial statements as a whole, it is not appropriate for the auditor to conclude on whether the use of the going concern basis of accounting is appropriate – indeed the reason for the disclaimer may directly relate to the inability to obtain audit evidence in relation to going concern. Therefore, the section on 'Conclusions relating to going concern' is not required.

Other information

ISA (UK) 705 states that unless required by law or regulation, when the auditor disclaims an opinion on the financial statements, the section on 'Other Information' should be deleted. However, the application material in ISA (UK) 705 also makes clear that the opinions in relation to the directors' report and strategic report (if applicable) required by the Companies Act 2006 are still required.

In addition, for entities that apply the UK Corporate Governance Code either because they are required to or voluntarily, the auditor is still required to report on certain aspects of the entity's compliance with the Code and the Listing Rules.

Opinions on other matters prescribed by the Companies Act 2006

As discussed above, even where there is a disclaimer of opinion, the auditor is still required to report on the directors' report or strategic report as the provisions in section 496 of the Companies Act 2006 continue to apply. However, given that there is a disclaimer 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. Although the information is consistent with the financial statements, the auditor is unlikely to be able to conclude whether, for example, it provides a fair review of the financial position and performance if the auditor has been unable to form a view on the financial position and performance in the financial statements.

Assuming that there are no further issues with either the strategic report or directors' report, the wording is amended as follows:

Because of the significance of the matter described in the basis for disclaimer of opinion section of our report, we have been unable to form an ~~In our~~ opinion, whether based on the work undertaken in the course of the audit:

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

Where only a directors' report has been prepared for a small company, as the requirements for the contents of the directors' report are more limited, the auditor may be able to issue the following opinion:

> Notwithstanding our disclaimer of an opinion on the financial statements, i~~I~~n 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

The auditor is still required to report on certain matters by exception. As there is a disclaimer of opinion, it is expected that the auditor is unable to obtain all of the information and explanations required for the audit and unable to determine whether adequate accounting records have been kept. However, further matters may also need to be reported – for example if the required disclosures in relation to directors' remuneration are not made or the disclaimer related to issues in relation to some of the company's branches.

Assuming there are no such further issues, the wording is amended as follows:

> Notwithstanding our disclaimer of an opinion on the financial statements, i~~I~~n the light of the knowledge and understanding of the company and its environment obtained in the course of the audit performed subject to the pervasive limitation described above, we have not identified material misstatements in the [strategic report or the] directors' report.
>
> Arising from the limitation of our work referred to above:
>
> - 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 adequate accounting records have been kept.
>
> We have nothing to report in respect of the following matters in relation to which the Companies Act 2006 requires us to report to you if, in our opinion:
>
> - ~~adequate accounting records have not been kept, or~~ returns adequate for our audit have not been received from branches not visited by us; or
> - the financial statements are not in agreement with the accounting records and returns; or
> - certain disclosures of directors' remuneration specified by law are not made~~; or~~
> - ~~we have not received all the information and explanations we require for our audit~~[; or
> - the directors were not entitled to prepare the financial statements in accordance with the small companies regime and take advantage of the small companies' exemptions in preparing the directors' report and from the requirement to prepare a strategic report].

Responsibilities of directors

No changes are needed.

Auditor's responsibilities for the audit of the financial statements

When the auditor disclaims an opinion on the financial statements, the description of the auditor's responsibilities is included directly within the audit report as it is not appropriate to include it within an appendix or to refer to the description on the FRC's website. The description of the responsibilities itself is shortened significantly to include only the following:

- A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with International Standards on Auditing (UK) and to issue an auditor's report;
- A statement that, however, because of the matter(s) described in the basis for disclaimer of opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and

- The statement about auditor independence and other ethical responsibilities.

> Our responsibility is to conduct an audit of the company’s financial statements in accordance with International Standards on Auditing (UK) and to issue an auditor’s report.
>
> However, because of the matter described in the basis for disclaimer of opinion section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.
>
> 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 the provisions available for small entities, in the circumstances set out in Note [X] to the financial statements], and we have fulfilled our other ethical responsibilities in accordance with these requirements.

Where the auditor has taken advantage of an exemption for the audits of ‘small entities’ provided in paragraphs 6.11, 6.12 or 6.13 of the FRC’s Ethical Standard in relation to non-audit services or partners/statutory auditors joining the entity, the auditor is required to disclose this as set out above.

Paragraph 29-1 of ISA (UK) 700 (Revised November 2019) requires the auditor to explain the extent to which the audit is considered capable of detecting irregularities, including fraud. The standard does not specify where this explanation is to be included in the auditor’s report. The FRC’s Bulletin includes it under the Auditor’s Responsibilities section. However, when a disclaimer of opinion is made by the auditor, and the auditor is required by ISA (UK) 705 (Revised June 2016) to amend the description of the auditor’s responsibilities to only include certain statements, as described above, it would not be appropriate for the explanation required by paragraph 29-1 of ISA (UK) 700 to be included under the section on Auditor’s Responsibilities and it should therefore be moved to another section of the auditor’s report.

Use of the audit report

ICAEW guidance within Technical Release 01/03AAF (Revised), The Audit Report and Auditors' Duty of Care to Third Parties, includes clarification language stating that the audit is performed for the benefit of the members, as a body, in accordance with the Companies Act 2006 and case law. This wording is also referred to as “Bannerman” wording.

The guidance in Technical Release 01/03AAF (Revised) states that this paragraph is suitably placed as the final section of the audit report with a heading “Use of our report”.

Assuming that the entity is a company, the typical company wording is used as follows:

> This report is made solely to the company’s members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company’s members those matters we are required to state to them in an auditor’s report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company’s members as a body, for our audit work, for this report, or for the opinions we have formed.

It will remain for each firm to decide its own individual approach to the management of audit risk, whether to include the above wording and if so, in which section of the audit report. However, as the guidance in Audit 1/03 makes clear, while a third party's use of an audit report presents uncertainty for auditors, the best risk management policy is for firms to take the steps that are necessary to carry out quality audits.

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]

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* Source: CAW, 2020 – Interbrand, Best Global Brands 2019

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