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Much ado about audit opinions

Themin SUWARDY
Singapore Management University, tsuwardy@smu.edu.sg

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COMMENTARY

Much ado about audit opinions

> With better understanding of the various types of modified opinion, investors can react appropriately to the news of companies failing to get a clean opinion. More importantly, they should ask tougher questions about key audit matters at annual general meetings even when clean opinions are issued.

By Themin Suwardy

IF we ever need proof that audit opinion matters, look no further than what happened to IHH Healthcare Bhd.

KPMG issued in early April a "qualified opinion" on the biggest publicly listed hospital operator in Asia. Investors were clearly spooked, and the stock fell 5 per cent in its largest single day move, down 8.4 per cent over the course of five days.

There are many other examples of stock price plunges and even listing suspensions for companies that fail to get a clean audit opinion.

This brings us to a key question: What exactly is an audit opinion, and what purpose does it serve for companies and investors?

An audit opinion is the summary opinion arrived at the end of an extensive audit process. For most companies, the most common outcome is an "unmodified opinion", often referred to as an "unqualified" or colloquially, a "clean" audit opinion. It means that the auditors have found that the financial statements were prepared, in all material respects, in accordance with the applicable financial reporting framework.

The problem is that investors tend to associate audit opinions in a binary perspective: clean versus dirty. This is not quite right, as there are nuances to why an audit opinion is not clean.

Auditors perform their duties as required under the Singapore Standards on Auditing (SSAs). Specifically, in forming their opinion, auditors assess the appropriateness of selection and application of accounting policies, the reasonableness of estimates and assumptions used by management, and the appropriate level of disclosures that would allow users to understand the financial statements.

Auditors may discover that accounts are not correctly reported and propose audit adjustments to correct these errors. One can assume that if management and directors produce high quality financial statements, the number of errors that need audit adjustments would be minimal.

The proposed audit adjustments could be caused by factual errors, misclassifications or those arising from errors related to projections or those that involved judgments and accounting estimates. In the 2014 Accounting and Corporate Regulatory Authority-Singapore Management University (Acra-SMU) study on audit adjustments, 87 per cent of errors detected and needing audit adjustments were either factual or misclassifications.

Assuming that all materials errors are corrected in the eventual financial statements, auditors will proceed to issue their clean opinion. In an audit committee seminar earlier this year, Acra indicated that 92 per cent of listed companies receive clean opinions.

QUESTIONS RAISED

Of course, questions are often raised when companies that receive clean opinions tumble in the following year. For example, Midas Holdings and Noble Group received clean audit opinions. In the UK, the Financial Reporting Council has asked auditors to raise their professional scepticism in dealing with management assertions and assumptions.

What about the other 8 per cent that do not get a clean opinion? Well, these are the ones that make the headlines.

Unfortunately, many investors are not familiar with the nuances of modified opinions and assume that if unmodified opinion translates to "clean", then everything else must be "dirty". There are in fact, three types of modified opinions: a qualified opinion, an adverse opinion and a disclaimer of opinion.

Qualified opinions are issued when material misstatements are present, but not pervasive enough to render the entire financial statement meaningless. In other words, there may be disagreement with specific transactions or treatments, but the rest of the financial statements are nevertheless prepared accordingly. This is often referred to as an "except for" opinion.

A case in point – the auditors of Annica announced that it was unable to ascertain if a receivable arising from the disposal of a business unit could be recovered or collected. Except for this matter, the auditors opined that the rest of the financial statements were presented appropriately.

The qualified opinion issued by KPMG for IHH related to ongoing investigations in Fortis Healthcare, which was acquired just a month before the end of its financial year, making it hard to conclude on the impact of the investigations.

In the last year, qualified opinions for various matters have also been issued for New Silkroutes Group, Falcon Energy, Food Empire and Oceanus.

An adverse opinion is one where the auditors believe that the errors, individually or in the aggregate, are pervasive and render the financial statements unreliable. It is the worst opinion that an auditor can issue, and it is not done lightly. Thus, adverse opinions are rare. One example would be iDimension, listed on Bursa Malaysia. Auditors disagreed with the management's deconsolidation of a subsidiary and believed that the resulting financial statements were not reliable.

Finally, a disclaimer of opinion is used when auditors are unable to arrive at an opinion, either due to the inability to form an opinion due to lack of audit evidence or when there are "going concern" issues. The "going concern" concept underpins the preparation of financial statements and assumes that the entity will be able to continue operations for the foreseeable future.

"No opinion" conclusions have been issued in the last few months for logistics provider Vibrant Group, offshore vessel builder Nam Cheong, coal mining company Resources Prima, Asiatravel.com and furniture maker Lorenzo. In these cases, the auditors did not obtain enough audit evidence that the entities can operate on a going concern basis, which is an underlying assumption of the financial reporting framework.

EXPRESSING OPINION

Since the end of 2016, the enhanced audit report requirements have improved the communication process of how auditors arrive at their eventual audit opinion. Auditors are now required to express the basis of their opinion, including discussions on key audit matters (KAMs) and how they have been addressed in the conduct of the audit.

A recent PwC report examined 392 auditor's reports and found that on average, auditors noted 2.2 KAMs. The most common KAMs in Singapore audits include valuation of receivables, valuation of property, plant and equipment, impairment of goodwill and intangible assets, and revenue recognition. SGX RegCo said earlier this year that it expects KAMs to include matters that it has queried companies on during the year.

With better understanding of the various types of modified opinion, investors can react appropriately to the news of companies failing to get a clean opinion. More importantly, they should ask tougher questions about KAMs at annual general meetings even when clean opinions are issued.

The writer is associate professor of accounting (practice) and dean of postgraduate professional programmes at Singapore Management University