Understanding a financial statement audit
Preface

Role of audit

Since its introduction, the need for certain companies’ financial statements¹ to be audited by an independent external auditor has been a cornerstone of confidence in the world’s financial systems.

The benefit of an audit is that it provides assurance that management has presented a ‘true and fair’ view of a company’s financial performance and position. An audit underpins the trust and obligation of stewardship between those who manage a company and those who own it or otherwise have a need for a ‘true and fair’ view, the stakeholders.

Given the importance of its role, queries are often raised about the audit, the auditors and the stakeholders they serve. This publication aims to provide useful background information on what a financial statement audit is and the role of the auditor.

Definition of an audit

In general, an audit consists of evaluation of a subject matter with a view to express an opinion on whether the subject matter is fairly presented. There are different types of audits that can be performed depending on the subject matter under consideration, for example:

- Audit of financial statements
- Audit of internal control over financial reporting
- Compliance audit

This publication only focuses on audits of financial statements, which are undertaken to form an independent opinion on the financial statements of a company.

Companies prepare their financial statements in accordance with a framework of generally accepted accounting principles (GAAP) relevant to their country, also referred to broadly as accounting standards or financial reporting standards. The fair presentation of those financial statements is evaluated by independent auditors using a framework of generally accepted auditing standards (GAAS) which set out requirements and guidance on how to conduct an audit, also referred to simply as auditing standards.

This publication focuses in particular on financial statement audits of public companies (listed companies, whose shares are typically traded on a stock exchange)—what most people have in mind when discussing ‘audit’. Whilst care has been taken to keep explanations broadly applicable to most public company audits, requirements and practices will vary from country to country, and jurisdiction to jurisdiction. Descriptions are based on the current broad form and scope of audit, the future of which is currently under debate around the world and is open to change. This publication does not provide detailed explanation of all aspects of a financial statement audit and readers should refer to other sources for further information.

¹ See ‘Glossary of terms’ from page 13 onwards for more definitions.
Overview

Purpose of a financial statement audit

Companies produce financial statements that provide information about their financial position and performance. This information is used by a wide range of stakeholders (e.g., investors) in making economic decisions. Typically, those that own a company, the shareholders, are not those that manage it. Therefore, the owners of these companies (as well as other stakeholders, such as banks, suppliers and customers) take comfort from independent assurance that the financial statements fairly present, in all material respects, the company’s financial position and performance.

To enhance the degree of confidence in the financial statements, a qualified external party (an auditor) is engaged to examine the financial statements, including related disclosures produced by management, to give their professional opinion on whether they fairly reflect, in all material respects, the company’s financial performance over a given period(s) (an income statement) and financial position as of a particular date(s) (a balance sheet) in accordance with relevant GAAP. In many cases this is required by law.

Benefits of an audit

Auditors are generally and ultimately appointed by the shareholders and report to them directly or via the audit committee (or its equivalent) and others charged with governance.

However, many companies’ audited financial statements, and particularly public companies, are on public record. For large public companies, they may also be used by other parties for varying purposes (see the chart below). In addition to shareholders, these may include, for example, potential investors considering buying the company’s shares and suppliers or lenders who are considering doing business with it. A rigorous audit process will, almost invariably, also identify insights about some areas where management may improve their controls or processes. In certain circumstances the auditor may be required to communicate control deficiencies to management and those charged with governance. These communications add value to the company and enhance the overall quality of business processes.
Public vs. private companies

While companies of all sizes produce financial statements, the number of stakeholders interested in them would normally be larger for public companies and larger private companies, due to the number of individuals, businesses and organisations that interact with and are affected by them. Also, public companies’ financial statements are typically available to a larger number of users. In most jurisdictions, for public companies, there are additional requirements to comply with when preparing their financial statements. Larger public company audits are typically more complex and also used by even more market participants.

Audit environment

The changing economic and legal environment has significant implications for a company’s operations and financial reporting, and changes in the business, economy and laws and regulations generally increase the level of risks affecting the business and require adequate response and disclosure in the financial statements. This also affects the way an audit is conducted, since the auditor’s work needs to be scaled to address increased risks of material misstatement of the financial statements.

In the current environment, auditors have to take into account various evolving factors that may result in additional challenges (see the chart opposite). When a company is comprised of multiple entities there are additional complexities that need to be addressed. These considerations are likely to complicate matters further when the company has locations in different countries and therefore may span different regulatory requirements (see ‘multi- location audits’ below).
Audit opinion

The management of a company is responsible for preparing the financial statements. The auditor is responsible for expressing an opinion indicating that reasonable assurance has been obtained that the financial statements as a whole are free from material misstatement, whether due to fraud or error, and that they are fairly presented in accordance with the relevant accounting standards (e.g., International Financial Reporting Standards).

There are clear frameworks from independent auditing standard setters which provide rules and guidelines for how an audit should be carried out and the level of assurance obtained. It is the auditor’s responsibility to plan and conduct the audit in such a way that it meets the applicable auditing standards and sufficient appropriate evidence is obtained to support the audit opinion. However, what constitutes sufficient appropriate evidence is ultimately a matter of professional judgement. The auditor considers a number of factors in determining whether financial statements are free of material misstatement, and in evaluating any misstatements identified. These factors require professional judgement, where auditors use their skill and experience to form a view based upon the evidence gathered on the financial statements taken as a whole.

The audit opinion is clearly stated as a separate paragraph in the audit report. The auditor issues a ‘clean’ opinion when it concludes that the financial statements are free from material misstatement.

Modified audit opinion

An audit opinion that is not considered ‘clean’ is one that has been modified. Auditors issue a modified audit opinion if they disagree with management about the financial statements. In practice this may be unusual as the company will typically make the necessary amendments to the financial statements and disclosures rather than receive a modified opinion. The auditors will also issue a modified opinion if they have not been able to carry out all the work they feel is necessary, or if they have been unable to gather all the evidence they need.

Auditors can also modify the audit report without modifying the opinion by adding additional paragraphs to draw users’ attention to specific significant matters. For example, if the auditors believe that there is some aspect of the financial statements that is subject to a material degree of uncertainty—even if fully disclosed—then they may draw attention to and emphasise this in the audit report. This is widely known as an emphasis of matter paragraph.

Going concern assumption

Under the going concern assumption, a company is viewed as continuing in business for the foreseeable future. Financial statements are prepared on a going concern basis, unless management either intends to liquidate the company or to cease operations, or has no realistic alternative but to do so. When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the company will be able to realise its assets and discharge its liabilities in the normal course of business.

If management considers that the company will not continue to operate for the foreseeable future, the financial statements must be prepared on a ‘liquidation’ (or ‘break-up’) basis—meaning that the value of their assets must take account of potential forced sales which will likely be significantly lower and their liabilities may be significantly higher.
Whether or not the going concern assumption is appropriate is therefore fundamental to the values at which the assets and liabilities are recognised in the company’s balance sheet. Thus, going concern refers to the basis on which the financial statements are prepared. It is not a guarantee of the company’s solvency.

In order to determine whether the going concern assumption is appropriate, management must consider the prospects for the business in the light of what the foreseeable future might bring. This requires significant judgement as no statement about the future can be guaranteed.

It is management’s responsibility to make a judgement on going concern. It is the auditor’s responsibility to consider whether there are any material uncertainties affecting management’s assessment and whether or not management’s judgement is appropriate. These judgements can be made only on the basis of what is known at the time, and facts and circumstances can quickly change in the current business and economic environment. What may be a reasonable assumption today, particularly in a fast-changing environment, may no longer be so a short time later.

The most common recent form of such uncertainty is where additional financing is needed to continue to develop a company’s business and fully fund its working capital. While management may be confident of obtaining additional funding in order to meet these needs, if there is no firm agreement with potential suppliers of finance, there is inherent uncertainty as to whether such funding will be raised.

If the auditors consider that there are any material uncertainties, even if clearly disclosed in the financial statements, then they must include an emphasis of matter paragraph in their audit report. If the auditors disagree with management’s assessment that the going concern assumption is appropriate for the company’s financial statements or if adequate disclosure of material uncertainties is not made, then their audit opinion will be modified.

The annual report

A company’s annual report is typically made up of the audited financial statements and a narrative, containing management’s description of the company’s performance and activities. The narrative part of the annual report is not normally audited. However, the auditors read the narrative statements in the annual report to identify any material inconsistencies with the audited information in the financial statements. If they find any such inconsistencies, they will communicate them to management and those charged with governance.

The financial statements, annual report and other documents all enable shareholders to understand how management has performed over the periods presented.

Other reports

In most jurisdictions, financial statements form only one part of the financial information that a public company prepares. In addition to publishing full financial statements every year, public companies typically also need to issue less detailed financial information at other points throughout the year. In most cases, auditors review this financial information, but this review is not an audit. Instead, the auditors make inquiries, apply analytical and other review procedures, and communicate whether anything has come to their attention that suggests the financial information is not prepared, in all material respects, in accordance with the relevant GAAP. A review does not involve testing or other corroborative procedures.

Before the audited financial statements are published, a public company will frequently make a preliminary announcement of its results for the year. These announcements are typically unaudited because the audit report on the financial statements has usually not been issued by that time. However, the company will generally ask its auditors to read the announcement prior to its release and inform them of any material inconsistencies which have come to their attention.
The audit process

Professional judgement and scepticism

In undertaking an audit, the auditors consider the mandatory and detailed GAAP that set out how a company should account for and disclose even the most complex transactions. However, many of the issues that arise in an audit—particularly those involving valuations or assumptions about the future—involve estimates to which the auditor must bring their professional judgement and experience to bear.

Indeed, many accounting measures can only ever be estimates that are inevitably based on imperfect knowledge or dependent upon future events. For example, if a company was involved in legal action, it would need to estimate the amount at which the case would be resolved; or if it was planning to sell an office building it owns, it would have to estimate the sale price.

In such cases, the auditor may determine the reasonable range of possible values, and consider whether the company’s estimates lie within that range. The uncertainties that affect this judgement need to be disclosed and—if they could have a material effect—the auditors may include an emphasis of matter paragraph in their report.

These are areas where the auditors must use their experience and skill to reach an opinion on the financial statements. The words ‘opinion’ and ‘true and fair’ are deliberately chosen to make clear that judgement is involved. They underline the fact that the auditor’s report is not a guarantee but rather reflects the auditor’s professional judgement based on work performed in accordance with established standards.

Auditing standards also require auditors to maintain professional scepticism—an attitude that includes a questioning mind and a critical assessment of audit evidence. The ability to think in a critical manner about how the current economic environment may affect the company’s financial statements, to identify significant risks of material misstatement, to develop appropriate audit responses, to obtain and assess the sufficiency and appropriateness of audit evidence and to reach well-informed professional judgements is integral to performing a quality audit.

Inherent limitations of an audit

An opinion is not a guarantee of an outcome, but rather a statement of professional judgement. The auditor cannot obtain absolute assurance that financial statements are free from material misstatement because of the inherent limitations of an audit. These are caused by a number of factors. For example, many financial statement items involve subjective decisions or a degree of uncertainty (e.g., accounting estimates). Consequently, such items are subject to an inherent level of uncertainty which cannot be eliminated by the application of auditing procedures.

It should not be assumed that every single fact and detail in a set of audited financial statements has been checked and verified by the auditors, and is therefore guaranteed to be 100 percent accurate. The auditor obtains reasonable assurance by gathering evidence through selective testing of financial records.

Fraud

Fraud has a corrosive effect on the trust necessary for companies to do business. Management is responsible for running the company and preventing and detecting fraud. Preventing and detecting fraud is difficult because fraud is intentionally hidden and may involve collusion by multiple participants.

Even though audits are properly performed in accordance with relevant GAAS, they may not detect material fraud. However, auditors are responsible for obtaining reasonable assurance that the financial statements are not materially misstated as a result of fraud.
Importantly however, if the auditors form suspicions of fraud in the course of their work a number of things will change, including their risk assessment (see below), the nature and extent of communications with those charged with governance, the nature and extent of audit procedures, and the evaluation of the effectiveness of the relevant internal controls and processes. The knowledge that an independent external audit will be conducted generally has a deterrent effect against fraud.

**The five phases of an audit**

Broadly, the audit process can be summarised in five phases:

1. **Planning**—Initial planning activities include formal acceptance of the client by the audit firm, verifying compliance with independence requirements, building the audit team and performing other procedures to determine the nature, timing and extent of procedures to be performed in order to conduct the audit in an effective manner.

2. **Risk assessment**—Auditors use their knowledge of the business, the industry and the environment in which the company operates to identify and assess the risks that could lead to a material misstatement in the financial statements. Those risks often involve a high degree of judgement and require a significant level of knowledge and experience by the auditor, particularly on large and complex engagements. This requires a good understanding of the business and its risks, which is typically built up over a number of years as part of the audit firm’s and auditor’s knowledge. It also means that the auditors need to be well informed about the industry and wider environment in which the company operates, and about what its competitors, customers, suppliers and—where relevant—regulators are doing.

3. **Audit strategy and plan**—Once the risks have been assessed, auditors develop an overall audit strategy and a detailed audit plan to address the risks of material misstatement in the financial statements. Among other things, this includes designing a testing approach to various financial statement items, deciding whether and how much to rely on the company’s internal controls, developing a detailed timetable, and allocating tasks to the audit team members. The audit strategy and plan is continually reassessed throughout the audit and adjusted to respond to new information obtained about the business and its environment.

4. **Gathering evidence**—Auditors apply professional scepticism and judgement when gathering and evaluating evidence through a combination of testing the company’s internal controls, tracing the amounts and disclosures included in the financial statements to the company’s supporting books and records, and obtaining external third party documentation. This includes testing management’s material representations and the assumptions they used in preparing their financial statements. Independent confirmation may be sought for certain material balances such as cash.

5. **Controls testing**—As businesses have grown more complex and sophisticated, and the costs of labour have risen, automated systems and processes have necessarily become much more prevalent. A well-run business will have its own systems and controls in place to operate efficiently, safeguard its assets, and to provide reasonable assurance that its transactions are properly reported and that its financial statements are complete and accurate. The auditors assess the effectiveness of these controls in preventing and mitigating the possible risk of material misstatement in those areas where the auditor plans to use such controls to adjust the nature, timing and extent of their testing. If they believe the controls are effective, and they have tested that they operated reliably throughout the year, then the level of substantive audit evidence needed to give an opinion may be reduced. Even if the controls are reliable, varying degrees of substantive audit evidence will still always need to be gathered.
Substantive testing
In addition to testing controls, the auditor is required to perform further procedures to gather evidence from substantive procedures (substantive audit evidence), which can include a combination of the following:

- Physically observing or inspecting assets (such as inventory or property, plant and equipment);
- Examining records to support balances and transactions;
- Obtaining confirmations from third parties the company does business with (such as its suppliers, customers and in particular the banks it uses);
- Checking elements of the financial statements by comparison to relevant external information and investigating any differences (for example, using an external market index to check pricing and valuations); and
- Checking calculations.

Finalisation—Finally, the auditors exercise professional judgement and form their overall conclusion, based on the tests they have carried out, the evidence they have obtained and the other work they have done. This conclusion forms the basis of the audit opinion.

Auditors interact with the company during all the phases of the audit process listed above. There will be continuing discussions and meetings with management, both at operational and senior executive levels, and with those charged with governance. Using their professional scepticism and judgement, auditors challenge management’s assertions regarding the numbers and disclosures in the financial statements.

The audit committee (or equivalent)
In public companies, it is generally the shareholders who ultimately approve the auditor’s appointment, and the auditors are primarily responsible to and overseen by those representing the shareholders’ interests with regards to financial reporting and internal controls.

Typically an audit committee (or its equivalent), acting as a largely independent body, will be charged with representing the shareholders’ interests. Companies may not necessarily have an audit committee and this interchange may be dealt with less formally but in an equivalent manner. The audit committee is a sub-committee of those charged with governance, and is typically made up of a majority of non-executive directors who are the shareholders’ representatives in relation to the external audit. They are usually responsible for overseeing the audit and evaluating the independence and performance of the auditors.

An important role of the audit committee is to assess and recommend the appointment or reappointment of the audit firm. The audit committee also provides a forum for the auditors to escalate and discuss any significant concerns they may have about any aspect of the financial statements prepared by management.

The chair of the audit committee has a vital role to play in assessing management’s tone from the top with respect to the company’s financial reporting.

As well as their public report on the financial statements, the auditors will typically have more detailed communications with the audit committee. These communications may include a description of how the audit was carried out, the audit plan, the auditor’s views about the company’s accounting practices (including accounting policies, estimates and disclosures), how the auditors satisfied themselves on the key issues that arose, and significant difficulties, if any, encountered during the audit. The auditors may also comment to the audit committee on their insights in areas such as the strength of the organisation’s internal control systems.
Auditor independence

Shareholders need to have confidence that the auditors have assessed relevant information objectively, and that they have scrutinised evidence critically and independently. Shareholders also want to be sure that the auditors have undertaken their work and made their judgements free from any bias, and without being influenced unduly by management who prepared the financial statements.

There are many detailed regulations and professional standards to which audit firms and all their staff must adhere, and which support both the fact and perception of auditor independence. In simple terms, auditors may not do anything that should be the role of management or that creates a mutual interest.

Specific requirements vary around the world, but generally include:

- Prohibiting the auditors from holding an interest in (whether financial or through close relationship with) the company they are auditing;
- Prohibiting the auditors from providing the company with certain services (such as implementation of accounting IT systems or hiring employees) that could compromise their objectivity; and
- Requiring key personnel on the audit to be changed from to time to time, so that fresh pairs of eyes are brought to bear including regular rotation of the lead audit partner.

The most important factor underpinning auditor independence is the attitude of mind that is instilled through audit training, practice, and the culture of the audit firm, and which auditors exhibit through professional scepticism in their work. The discipline of independence is core to an auditor’s approach and mindset.

Auditor appointment

The auditor’s appointment is generally and ultimately approved by the shareholders but the auditors are paid by the company itself. The audit committee takes responsibility for overseeing the auditor’s independence and performance, and for recommending to the company’s highest governing body (typically the board) whether their reappointment should be put to the shareholders at an annual general meeting. The audit committee also reviews the audit fee to satisfy itself that it is competitive yet sufficient to ensure a proper quality audit can be performed.

If a company is considering changing its auditors, the audit committee will take the central role, recommending to those charged with governance whether the auditor’s appointment should be reassessed, and if so, which other firm(s) should be considered for the role. This is typically conducted through a competitive tender process with multiple firms being considered.

In addition to the audit committee responsibility for reviewing the auditor’s performance, there are a number of bodies such as regulators and standard setters who play a key role in the oversight of the audit profession and the monitoring of audit quality.

Auditor appointment is more complicated in the case of multi-location audits (see ‘multi-location audits’ below), as in this situation the group auditor will need to perform and/or coordinate audits of components of the group (subsidiaries, etc.) to support the group audit opinion. The component audits may be performed by the lead audit firm (i.e. the firm providing an opinion on the group’s consolidated financial information), by another audit firm in the lead auditor’s network, or by another unconnected audit firm. The auditors of those components report to the lead auditor of the group for the purpose of the consolidated group financial statements. The lead auditor typically has sole responsibility for the audit opinion on the consolidated financial statements.
**Auditor qualifications and skills**

Auditors are generally qualified accountants who are members of a professional institute in their respective countries. Although this varies between countries, qualified accountants normally must meet certain educational requirements, take several years of studying and professional exams and have sufficient practical experience.

Becoming an auditor is a challenging process that requires a combination of significant academic study and a large amount of learning on-the-job. This means the people who qualify as auditors benefit both from an understanding of the principles of auditing, accounting, finance, law, business management, among other topics, and hands-on experience.

In addition to the technical knowledge, auditors need to have good analytical skills to be able to effectively analyse the company’s information, properly interpret the analysis, apply professional judgement and arrive at appropriate conclusions. Auditors must also possess broad communication skills (both verbal and written). As auditors communicate to the company’s senior management and those charged with governance, it is very important that they do so in a clear and professional manner.

Auditors possess the analytical and logical skills needed to evaluate the relevance and reliability of the systems and processes responsible for recording and summarising financial information. These skills enable auditors to understand how to gather and assess evidence to evaluate representations made by others.

Throughout their careers all auditors must undertake continuing professional development to maintain their qualifications. Most audit firms invest significant resources in training and professional development of their staff which go beyond the requirements of the territory professional regulations. Overall, the training that auditors receive provides them with a significant array of skills, which form the foundation for a wide range of careers in various fields and contribute to the overall recognition and high regard for audit professionals.

**Multi-location audits**

In many cases, a business comprises several legal entities (which may be located in different countries), whose results are consolidated into a single set of financial statements that present the financial position and performance of the consolidated group. Large companies may have dozens or even hundreds of entities. Audits of such clients normally involve audit teams from audit firms around the world performing work in different locations.

The lead auditor responsible for issuing the opinion on the consolidated group financial statements develops the audit strategy and defines the scope of work to be performed at each component (location, entity, etc.) of the group. The lead auditor communicates with the audit firms responsible for component audits and typically reviews component auditor’s work in order to obtain evidence to support an opinion on the group consolidated financial statements.

As a result, multi-location audits entail more complex considerations regarding audit strategy, planning, execution and communication.

**Multi-location audit considerations**

- Required procedures to obtain understanding of the component auditors by the lead auditor (e.g., evaluating their professional competence, etc.);
- Different regulatory requirements, e.g. different laws, regulations and accounting standards (which would need to be converted to a consistent set of standards for group accounts);
- Language and cultural differences;
- Emerging markets considerations (e.g., evolving laws and regulations, corporate governance practices, potentially higher business risks, etc.);
- Site visits of the company’s locations by the lead auditor around the world;
- Additional procedures to support timely, accurate two-way communications between the lead auditor and component auditors; and
- Review of the audit procedures performed by the component auditor(s).
1 Accounting standards, also known as financial reporting standards or General Accepted Accounting Principles (GAAP)
Accounting standards set out the requirements for the recognition, measurement, presentation and disclosure of transactions and events that are important to the financial statements. For example, International Financial Reporting Standards (IFRS) are issued by the International Accounting Standards Board (IASB).

2 Annual general meeting
An annual general meeting (commonly referred to as an AGM) is a formal meeting held once a year by a company, required by law, to which shareholders are invited.

3 Annual report
The annual report is a report issued by a company detailing its activities and financial performance during the preceding year. It includes the financial statements and may generally also include reports from those charged with governance (for example the chairman of the board of directors), a review of the company’s strategy and performance, information on risk management and governance, information for the shareholders and other information such as a corporate and social responsibility statement.

4 Assurance
Assurance refers to enhancing the user’s confidence in the information that is being reported. In a financial statement audit, the auditor obtains reasonable assurance about whether the financial statements are free of material misstatement.

5 Audit committee
The audit committee is a committee of those charged with governance, responsible for the oversight of a company’s financial reporting and accounting, financial regulatory compliance, financial risk management processes, and the engagement of and interaction with the company’s external auditor on behalf of the company’s shareholders. It is typically comprised of a majority of independent non-executive directors.

6 Audit report and audit opinion
The audit opinion is a key part of the audit report that accompanies the company’s financial statements in the annual report. It states the auditor’s conclusion on whether the financial statements, including disclosures are presented fairly in all material respects in accordance with the applicable financial reporting standards. The audit report and audit opinion can be ‘unmodified’ or ‘modified’.
7 Auditing standards, also known as Generally Accepted Auditing Standards (GAAS)
Auditing standards provide requirements and guidance for auditors regarding performing audit engagements. Auditing standards may be set by national or international organizations, such as the International Auditing and Assurance Standards Board (IAASB) and adopted by national regulatory bodies. Auditing standards enhance quality and consistency of audit engagements and strengthen public confidence in the auditing profession.

8 Balance sheet
A financial statement that presents a company’s financial position as of a specified date. It is also often referred to as ‘statement of financial position.’

9 Break-up basis
The break-up basis is used for preparing the financial statements of a company where management is unable to confirm that it is a going concern (see below). On this basis, assets and liabilities are included at the net value that would be realisable in the event of a forced sale or liquidation.

10 Disclosures
Disclosures are the inclusion of information in the financial statements, such as further analysis of the primary financial statements, a statement of principal accounting policies applied, or key assumptions relating to accounting estimates, including information required by law, financial reporting standards or other regulations. These are an integral part of the financial statements.

11 Emphasis of matter
A paragraph included in the auditor’s report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor’s judgement, is of such importance that it is fundamental to users’ understanding of the financial statements. An emphasis of matter does not affect the audit opinion but modifies the audit report to draw attention to specific matters disclosed in the financial statements.

12 Financial reporting standards
See accounting standards above.
13 **Financial statements**
What specifically must be in the financial statements is governed by local law and regulation and standards such as international financial reporting standards, however generally they must include a balance sheet (showing assets, liabilities and equity), income statement, cash flow statement and equity statement (showing changes in equity). These are typically also referred to as the primary statements. Usually financial statements are accompanied by additional disclosures (see the disclosures definition above).

14 **Generally Accepted Accounting Principles (GAAP)**
See accounting standards above.

15 **Generally Accepted Auditing Standards (GAAS)**
See auditing standards above.

16 **Going concern**
Management’s assumption that the company will continue to operate for the foreseeable future. Financial statements are prepared on a going concern basis, unless management either intends to liquidate the company or to cease operations, or has no realistic alternative but to do so. In these cases, the break-up basis is used (see above). The going concern basis is one in which the assets and liabilities of the business are realised and settled in the normal course of its activities.

17 **Income statement**
A financial statement that measures a company’s financial performance over a specific accounting period.

18 **Internal control systems**
The processes designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity’s objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

19 **Listed company**
A listed company is a company whose shares can be bought and sold by the general public and are listed on a stock exchange, such as the London Stock Exchange.
**Material/materiality**

Materiality is a concept used by both preparers and auditors of financial statements to help determine what information is important, what information should be disclosed in the financial statements, and to evaluate misstatements.

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the item or error judged in the particular circumstances of its omission or misstatement.

When determining whether a matter is material, the auditor also evaluates qualitative considerations, such as the impact of misstatements on debt covenants, key ratios, etc.

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**Misstated/misstatement**

A misstatement is a difference—arising from an error or fraud—between the amount, classification, presentation or disclosure of an item in the financial statements, and the amount, classification, presentation or disclosure that is required for that item to be in accordance with the applicable financial reporting standards.

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**Modified/modifications**

An audit opinion is modified when the auditor concludes that the financial statements are materially misstated, or the auditor has been unable to obtain sufficient appropriate audit evidence to reach a conclusion. A modified opinion could be:

- **A qualified opinion**—the auditor concludes that, except for specific matters explained in the audit report, the financial statements give a true and fair view;

- **An adverse opinion**—the auditor concludes that the financial statements do not give a true and fair view;

- **A disclaimer of opinion**—the auditor concludes that the extent of their inability to obtain sufficient appropriate audit evidence is such that it is not possible to form an opinion on the financial statements.

The audit report can also be modified through an emphasis of matter paragraph without altering the audit opinion (see the emphasis of matter definition above).
23 **Narrative statements**
Management’s narrative statements comprise information included in the annual report, outside the financial statements, on matters such as the company’s strategy, risks, activities and performance for the year.

24 **Primary statements**
See financial statements above.

25 **Reasonable assurance**
In the context of an audit of financial statements, a high, but not absolute, level of assurance.

26 **Regulatory bodies**
These are bodies which, among other things, have responsibility in relation to the qualification and supervision of auditors. Other bodies have responsibility for:

- Accounting and financial reporting standard setting: for example, the International Accounting Standards Board (IASB).
- Auditing standard setting: for example, the International Auditing and Assurance Standards Board (IAASB).

27 **Substantive audit evidence**
Audit evidence obtained through substantive audit testing procedures, including for example:

- Physical observation or inspection of assets (such as inventory or property, plant and equipment);
- Examination of records to support balances and transactions;
- Obtaining confirmations from third parties (for example the banks it uses);
- Checking elements of the financial statements by comparison to relevant external third party information; and
- Checking calculations.

28 **True and fair**
‘True and fair’ is a concept in relation to a set of financial statements that has no precise definition. It takes into account the inherent judgements required in preparing (and auditing) financial statements. Financial statements will not be ‘true and fair’ unless the information they contain is sufficient in terms of both quality and quantity to satisfy the reasonable expectations of users of the financial statements.

29 **Working capital**
A financial metric that measures the resources available to a company to finance its day-to-day operations. It is typically calculated by deducting current liabilities from current assets.