Local Audit Reset and Recovery Implementation Guidance (LARRIG) 03

Modifications of independent auditor's opinions on the financial statements for audits of English local authorities

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About Local Audit Reset and Recovery Implementation Guidance

Local Audit Reset and Recovery Implementation Guidance notes (LARRIGs) are prepared and published by the National Audit Office (NAO) on behalf of the Comptroller and Auditor General (C&AG) who has power to issue guidance to auditors under Schedule 6 paragraph 9 of the Local Audit and Accountability Act 2014 (the Act). LARRIGs are prepared and published with the endorsement of the Financial Reporting Council (FRC) and are intended to support the reset and recovery of local audit in England. The guidance in LARRIGs supports auditors in meeting their requirements under the Act and the *Code of Audit Practice* published by the NAO on behalf of the C&AG.

LARRIGs are numbered sequentially and published on the NAO's website. LARRIGs are intended to be in place for a limited period of time and will be withdrawn once no longer necessary.

LARRIGs are designed specifically to assist local auditors in forming their own understanding of the requirements of the Code during the reset and recovery of the local audit system. Auditors are required to have regard to LARRIGs, which means that they must take into account the guidance issued by the NAO, and, if they decide not to follow it, they must give clear (in the sense of objective, proper, and legitimate) reasons within audit documentation as to why they have not followed the guidance. LARRIGs are in no way intended as a substitute for the exercise of the independent professional skill and judgement of a local auditor in deciding how to apply the NAO's guidance or when providing explanations as to why guidance has not been followed.

Local auditors should not assume that LARRIGs are comprehensive or that they will provide a definitive answer in every case.

This LARRIG is relevant to local auditors of local public bodies covered by the Local Audit and Accountability Act 2014 and the *Code of Audit Practice* **except** auditors of local NHS bodies including NHS foundation trusts and smaller authorities as defined by the 2014 Act.

Introduction and context

The guidance within this document is prepared to assist auditors in meeting their responsibilities under the Code of Audit Practice (the Code).

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Section 1: Status of guidance

1. This guidance is to assist auditors of local government financial statements to understand the impact of the proposed changes to the Accounts and Audit Regulations 2015 on the auditor's opinion. It may also assist preparers and users of these financial statements to understand the different forms that the auditor's opinion may take. These changes, proposed because of the exceptional circumstances within the sector, will require relevant bodies listed under Schedule 2 of the Local Audit and Accountability Act 2014 to publish audited annual accounts for the financial years 2015/16 to 2022/23 by 13 December 2024 (a 'backstop' date). This backstop date creates circumstances which may require auditors to consider modifying their audit opinion for annual accounts affected by this measure. It is anticipated that it will result in many modifications of a particular type – a 'disclaimer of opinion'.
2. Section 2 of this guidance considers why the backstop may give rise to the need for a modified opinion on the financial statements. Section 3 then discusses the different types of modified opinion, including disclaimers of opinion (paragraphs 8-12), as well as the circumstances in which they may arise. It also details other disclosures in the independent auditor's report which do not constitute modifications of the opinion in Section 4. This guidance does not cover the auditor's responsibilities for value for money arrangements reporting, or their wider powers and responsibilities, or circumstances relating to the issuance of the audit certificate.
3. While this guidance focuses on the impact the disclaimer may have on the auditor's opinion on the financial statements, it is important to remember that the timely delivery of high-quality financial reporting and external audit is a collective enterprise where both auditors and local authorities have roles to play. A well-governed entity with effective internal controls and accurate and timely financial reporting help underpin a high-quality timely audit. Similarly, the auditor has public interest responsibilities to perform the audit within a reasonable timeframe. The proposed measures should help facilitate a return to the timely delivery of audited financial statements by both the local authorities listed under Schedule 2 of the Local Audit and Accountability Act 2014 and their auditors.

Section 2: The impact of the backstop

4. Two key objectives of any auditor are to obtain sufficient appropriate audit evidence to support their audit opinion, and to then report their opinion on the financial statements based on the evidence obtained.

5. The need for a modified opinion may arise because the backstop creates time constraints that prevent the auditor from completing all the necessary audit procedures to obtain sufficient appropriate audit evidence to support the audit opinion. Other reasons for a modification may exist, such as other circumstances where the auditor has not been able to obtain sufficient appropriate audit evidence for reasons other than the backstop, or where the auditor has identified material misstatements in the financial statements.

Section 3: Modified Opinions

6. Two primary factors contribute to the kind of modified opinion which auditors can give.[1] These are:

    - whether the auditor has been able to obtain sufficient appropriate audit evidence to form an opinion on whether the financial statements are free from material misstatement; and
    - how pervasive any actual or potential error may be to the financial statements.

7. As a result, audit opinions may be modified in several ways, which are set out below. The diagram on page 9 of this guidance sets out the decision-making process an auditor follows when considering a modified opinion, and the circumstances that apply in each case. Auditors may use the guidance here to provide users of financial statements with a better understanding of why they have modified their report.

Disclaimer of Opinion

8. This type of modified opinion is anticipated to be the most common type issued by local auditors because of the backstop. Where the auditor, in making reasonable efforts to perform the audit:

    - has not been able to obtain sufficient appropriate audit evidence on which to base an opinion, and
    - concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive,

[1] International Standard on Auditing (UK) 705 (Revised June 2016), *Modifications to the Opinion in the Independent Auditor’s Report*.

the auditor 'disclaims' their opinion entirely. This is illustrated by the diagram included in this guidance on page 9.

9. An inability to obtain sufficient appropriate audit evidence may arise from:

- circumstances beyond the control of the audited local authority;
- circumstances relating to the nature or timing of the auditor's work; or
- limitations imposed by management.

10. The proposed backstop creates circumstances which create an inability for the auditor to obtain sufficient appropriate audit evidence which is beyond the control of the local authority. This is because it creates a legal requirement for the audited financial statements to be published by a set date, preventing the auditor from arriving at a position where they can opine on the financial statements on the basis of sufficient appropriate audit evidence. This statutorily imposed limitation of scope may lead the auditor to conclude that a disclaimer of opinion is appropriate. A disclaimer covers the entirety of the financial statements, and the addressees of the auditor's report should not place any reliance on the work of the auditor for any part of them. This will include work that is usually performed by auditors on the risk of fraud in the financial statements.

11. A disclaimer of opinion in these circumstances is not necessarily an indication of failure by management to adequately prepare the financial statements on a timely basis and to provide the auditor with all the evidence necessary to audit them. Where the opinion has been disclaimed, the auditor is required to explain the basis for the disclaimer in the auditor's report. They are also required to report any other matter of which they are aware that would have required a modification to the opinion. Guidance on what the auditor's report should include in these circumstances is set out in LARRIG 02, paragraphs 28 to 33.

12. The auditor may also disclaim their opinion if they are prevented by management from obtaining sufficient appropriate audit evidence (a 'limitation of scope'). Depending on the circumstances, this could alternatively give rise to a qualified opinion (see below). Where such circumstances arise, the auditor should make sure that these are clearly communicated within the auditor's report.

Qualified Opinion

13. Where an auditor concludes that there is either a lack of sufficient appropriate audit evidence, or actual (or potential) material misstatements in a set of financial

statements, but that the actual (or potential) effects on the financial statements are not pervasive, then the qualification of the auditor's opinion only applies to those items. For example, if the issue is limited to a specific set of balances, transactions, or disclosures, the auditor could report that 'other than' the specific items described, they have concluded that the financial statements are otherwise true and fair.

14. An auditor may also be prevented by management from obtaining sufficient appropriate audit evidence. This represents a management-imposed limitation of scope. These circumstances may give rise to either a qualified opinion or a disclaimer of opinion, depending on whether the impact is pervasive to the financial statements as a whole. It is important to note that this differs from the circumstances whereby the backstop results in the auditor disclaiming their opinion (see above).

Adverse Opinion

15. Where the auditor concludes on the basis of sufficient appropriate evidence that material and pervasive misstatements exist that undermine the reliability of the financial statements as a whole then they give an 'adverse' opinion.

Section 4: Additional disclosures in the Independent Auditor's Report which are not modifications of the opinion

16. Users of financial statements may also find additional disclosures within the auditor's report, which do not affect or change the auditor's opinion, which remains unqualified. These include:

An Emphasis of Matter[2]

17. 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 judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Key audit matters[3]

[2] ISA (UK) 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.

[3] ISA (UK) 701, *Communicating Key Audit Matters in the Independent Auditor's Report*.

18. A very small number of local authorities are also classed as Public Interest Entities (PIEs). In these instances, the auditor is required to communicate those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements. These are included in the auditor's report under a separate section. The auditor is still required to communicate key audit matters in auditor's reports for PIEs even when the opinion has been disclaimed.

Certain disclosures relating to going concern[4]

19. The auditor is required to make certain additional disclosures relating to the use of the going concern basis for the preparation of the financial statements. Under the CIPFA Code of Practice on Local Authority Accounting, bodies can only be discontinued under statutory prescription and are required to prepare their financial statements on the basis that their functions will continue in operational existence for the foreseeable future.[5] This means that the local government auditor applies a 'continued provision of service approach', unless there is clear evidence to the contrary. It is therefore highly unlikely that the auditor will modify their opinion in relation to going concern. Where the auditor does include a disclaimer of opinion in the auditor's report, they will not include any commentary on going concern.

20. It is important to note that the going concern assumption is not negated by the circumstances whereby a local authority issues a Section 114 notice. These are issued by the council's Section 151 officer in circumstances where they believe that the local authority is about to incur expenditure deemed unlawful by the Local Government Finance Act 1988. These notices can be issued for several reasons, but the most common is where there is an expectation that the authority's expenditure will exceed income for a particular financial year. This is not permitted under the 1988 Act.[6]

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[4] The relevant auditing standard is ISA (UK) 570.

[5] For example, see CIPFA / LASAAC, *Code of practice on local authority accounting in the United Kingdom 2022/23*, paragraphs 2.1.2.9, 3.4.2.23. For further guidance, see Supplementary Guidance Note (SGN) 01 Going Concern – Auditors' responsibilities for local public bodies.

[6] Institute for Government, '[Local government section 114 (bankruptcy) notices]', October 2023.

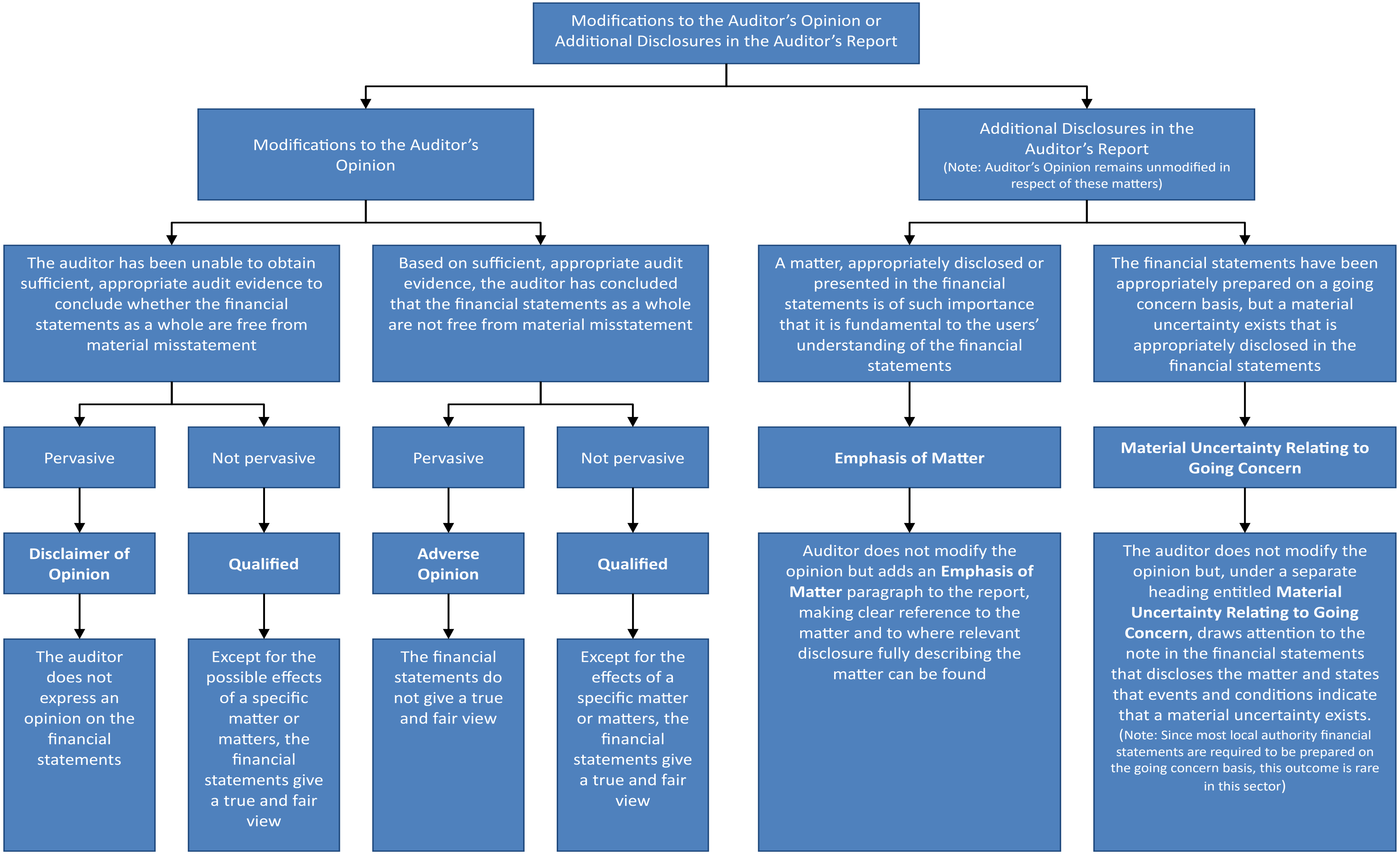
Departure from LARRIG Guidance and Raising Technical Issues or Queries

21. Where auditors judge that they need to depart from the guidance in a particular engagement, this should be drawn to the attention of the NAO and the FRC’s Director of Local Audit who will consult with the appropriate organisations within the local audit system to resolve the issue.

22. Auditors in firms should raise queries within the firm, in the first instance, so that the relevant technical support service can consider whether to refer queries to the NAO.

23. All queries related to LARRIGs should be submitted to the NAO’s ’s Local Audit Code and Guidance (LACG) team by e-mailing LACG.queries@nao.org.uk. Auditors are reminded that only nominated contacts can email LACG Queries. Please email lacg@nao.org.uk to request additional contacts to be added, including details of role and supporting explanation.

24. The NAO also engages with the firms through its Local Auditors Advisory Group (LAAG) and supporting technical networks to consider any emerging regime-wide technical issues on a timely basis. Auditors should follow their in-house arrangements for bringing significant emerging issues relating to the reset and recovery of the local audit system to the attention of their supplier’s representative on LAAG or the relevant technical network.


Modifications to the Auditor’s Opinion or Additional Disclosures in the Auditor’s Report
Modifications to the Auditor’s Opinion
Additional Disclosures in the Auditor’s Report
(Note: Auditor’s Opinion remains unmodified in respect of these matters)
The auditor has been unable to obtain sufficient, appropriate audit evidence to conclude whether the financial statements as a whole are free from material misstatement
Based on sufficient, appropriate audit evidence, the auditor has concluded that the financial statements as a whole are not free from material misstatement
A matter, appropriately disclosed or presented in the financial statements is of such importance that it is fundamental to the users’ understanding of the financial statements
The financial statements have been appropriately prepared on a going concern basis, but a material uncertainty exists that is appropriately disclosed in the financial statements
Pervasive
Not pervasive
Pervasive
Not pervasive
Emphasis of Matter
Material Uncertainty Relating to Going Concern
Disclaimer of Opinion
Qualified
Adverse Opinion
Qualified
The auditor does not express an opinion on the financial statements
Except for the possible effects of a specific matter or matters, the financial statements give a true and fair view
The financial statements do not give a true and fair view
Except for the effects of a specific matter or matters, the financial statements give a true and fair view
Auditor does not modify the opinion but adds an Emphasis of Matter paragraph to the report, making clear reference to the matter and to where relevant disclosure fully describing the matter can be found
The auditor does not modify the opinion but, under a separate heading entitled Material Uncertainty Relating to Going Concern, draws attention to the note in the financial statements that discloses the matter and states that events and conditions indicate that a material uncertainty exists.
(Note: Since most local authority financial statements are required to be prepared on the going concern basis, this outcome is rare in this sector)