

## **Unqualified Audit Report and Non-Compliance with IFRS: Interview Evidence**

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### **ABSTRACT**

This study aims to explore the reasons why an unqualified audit report was issued despite non-compliance with the International Financial Reporting Standards (IFRS) disclosure requirements. To achieve this objective, a semi-structured interview was used to gather opinions of auditors. Our findings suggest that materiality and true and fair view could be the reasons for issuing a clean audit report despite significant non-compliance with accounting standards. The findings of this study might assist regulators, standard setters and professional accounting bodies in monitoring and safeguarding the quality of financial reporting.

*Keywords:* Audit report, IFRS, materiality, true and fair view

### **INTRODUCTION**

Compliance with accounting standards or the International Financial Reporting

Standards (IFRS) in the preparation of financial statements implies that companies provide sufficient information to enable stakeholders in making economic decisions about the company. Non-compliance with the IFRS either would result in misleading, inadequate or inaccurate disclosure in the financial statements. Hence, compliance with the IFRS is said to be as important as the standards themselves (Hodgdon, Tondkar, Harless, & Adhikari, 2008). Generally, non-compliance with accounting standards would lead to qualification of audit opinion or audit report (Cairns, 2001; Forker, 1992).

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Prior literature, however, has shown that companies may not necessarily comply with accounting standards (e.g. Ahmed & Nicholls, 1994; Tai, Au-Yeung, Kwok, & Lau, 1990). Worryingly, prior studies also highlight that auditors sometimes issue an unqualified or clean audit report despite significant (or material) non-compliance with accounting standards (e.g. Abdullah, Sulaiman, Ismail, & Sapiei, 2012; Al-Shammiri, Brown, & Tarca, 2008; Glaum & Street, 2003). Siddique and Podder (2002) in their study of the effectiveness of audit of banks in Bangladesh also found that clean audit reports were issued although the banks had overstated their profits. Therefore, it is questionable when non-compliance with accounting standards does not warrant qualified audit opinion. The following research question was addressed in this study: Does non-compliance with IFRS disclosure requirements warrant a qualified opinion?

To the best of our knowledge, the issue has not been investigated in any study so far. This study aims to contribute to the extant literature on compliance with mandatory disclosure and audit report by exploring the potential reasons why an unqualified (or clean) audit report was issued despite significant non-compliance with accounting standards disclosure requirements. The findings of this study might help regulators, standard setters and professional accounting bodies in monitoring and safeguarding the quality of financial reporting.

## LITERATURE REVIEW

### Accounting Standards and True and Fair View

Reporting requirements, rules and regulation on accounting in Malaysia are stipulated in the Companies Act 1965 (CA1965) and the Financial Reporting Act 1997 (FRA1997). CA 1965 requires the directors of companies to prepare their accounts in accordance with the approved accounting standards and the accounts must give a *true and fair view* (TFV) of the state of affairs of the companies. The approved accounting standards are defined in the FRA1997 as accounting standards, which are issued or adopted by the Malaysian Accounting Standards Board (MASB). Subsequent to the full convergence announcement in 2008, the MASB issued the Malaysian Financial Reporting Standards (MFRS), which is fully IFRS-compliant and applies to all companies other than private entities<sup>1</sup> beginning 1 January 2012.<sup>2</sup> The MASB accounting standards are mandated by law and the enforcement of the standards were

<sup>1</sup>Private entities are private companies incorporated under the Companies Act 1965 that are not required to prepare and lodge any financial statements under any law administered by the Securities Commission (SC) or Bank Negara; and are not subsidiaries or associates or jointly controlled by an entity that is monitored or administered by the SC or Bank Negara

<sup>2</sup>Prior to 1 January 2012, all companies other than private entities applied the Financial Reporting Standards (FRS)

entrusted to the three regulatory agencies, namely, the Securities Commission (SC), the Central Bank of Malaysia (Bank Negara) and the Companies Commission of Malaysia (CCM). The companies' financial statements shall be deemed not to have complied with the requirement of any law administered by these bodies unless they have been prepared and kept in accordance with MASB approved accounting standards. The company that complies with the approved accounting standards is also required to make an explicit and unreserved statement of such compliance in the notes to accounts, and the financial statements shall not be described as complying with the approved accounting standards unless they comply with all the requirements of the standards.

Despite the paramount importance of TFV in the preparation of financial statements, the definition of TFV is not given in any law (Alexander, 1993; Evans, 2003). Hence, TFV or fair presentation of financial statements is normally achieved by compliance with accounting standards. Though compliance with accounting standards is emphasised, the CA1965 also provides relief for directors for not complying with the accounting standards if they believe that compliance would not give a true and fair view of the results of the business and the state of affairs of the company or group.<sup>3</sup> This relief is also referred to as 'true and fair view override' of accounting standards (Nobes, 2009; Alexander & Archer, 2003). The directors who choose to use this relief are required by the CA1965<sup>4</sup> to state the reasons for

non-compliance with approved accounting standards in the notes to the accounts of financial statements.

### **Audit Report**

The Companies Act 1965 requires auditors to state in the auditor's report whether the companies' accounts are prepared in accordance with the provisions of the Act so as to give a true and fair view of the company's affairs and in accordance with the applicable approved accounting standards.<sup>5</sup> An unqualified (or clean) opinion is expressed when the auditor is able to conclude that the financial statements give a true and fair view (or are presented fairly in all material respects) in accordance with the applicable approved accounting standards. In other circumstances, the auditor is required to either disclaim an opinion or qualified or adverse opinion depending on the nature of the circumstances. According to the International Auditing Practice Statement (IAPS)<sup>6</sup>, the auditor does not express an unqualified opinion if the financial statements contain any departure from the IFRS<sup>7</sup> and the departure has a material

<sup>3</sup>Subsection 166A (4)

<sup>4</sup>Subsection 166A(5)

<sup>5</sup>Section 174 of CA1965

<sup>6</sup>IAPS is a supplement to ISA700, "The Auditor's Report on Financial Statements". IAPS provides guidance on the application of ISA700 in cases where financial statements are prepared using the IFRS or include a reference to the IFRS

<sup>7</sup>For convenience, this paper refers to MFRS, IAS and FRS as IFRS

effect on the financial statements. Such a departure results in a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

### **Materiality Concept**

Materiality is an important issue because it involves an auditor's decision of whether an item should be disclosed or adjusted in the financial statements, and accordingly, affects the audit opinion (Nelson, Smith, & Palmrose, 2005). According to the materiality concept, the approved accounting standards need not be applied to immaterial items. Disclosure or formal adjustment error is not required if the item is immaterial and does not affect users' decision making (Acito, Burks, & Johnson, 2009). Hence, it can be assumed that an item was immaterial if it was not disclosed in the financial statements (Icerman & Hillison, 1991). It is important to note that the concept of materiality is also closely related to the characteristics of relevance. Thus, the management may have the tendency not to disclose information if they perceive users to have no interest in such information (i.e. it is irrelevant to the specific user's needs) (Ernst & Young, 2010).

Despite the importance of materiality in auditors' reporting decisions, there is no clear guideline for determining materiality (Ernst & Young, 2010; Acito et al., 2009). The accounting and auditing standards only provide general guidelines on how to determine materiality; thus, many of

the decisions regarding materiality depend on the professional judgement of auditors and preparers, where both quantitative and qualitative factors<sup>8</sup> must be considered (Acito et al., 2009). Therefore, whether an item is material or not in a particular context is perhaps a highly subjective decision and depends on professional judgement (Alexander & Nobes, 2007).

Since materiality depends on the auditor's judgement, it is not surprising that Iskandar and Iselin (1999) found that the magnitude of disclosure materiality threshold varies among auditors; it ranges between 2.7% and 20%. Several researchers also argue that the vagueness in determining materiality provides an opportunity for both companies' management and auditors to misuse the materiality concept to achieve their financial reporting objectives, such as meeting earnings forecasts (e.g. Acito et al., 2009; Wright & Wright, 1997). A concern regarding the materiality issue was raised by the Securities and Exchange Chairman Arthur Levitt; it was quoted by Messier, Martinov-Bennie and Eilifsen (2005) as follows:

...some companies misuse the concept of materiality. They intentionally record errors within

<sup>8</sup>Quantitative factors normally are based on 5% of net income (rule of thumb), whereas examples of qualitative factors that must be considered are regulatory requirements, whether it involves unlawful transactions and whether it affects loan covenants or other contracts (Acito et al., 2009)

a defined percentage ceiling. They then try to excuse that fib by arguing the effect on the bottom line is too small to matter. If that's the case, why do we work so hard to create these errors? Maybe because the effect can matter, especially if it picks up the last penny of the consensus estimate. When either management or the outside auditors are questioned about these clear violations of GAAP, they answer sheepishly... "It doesn't matter. It's immaterial." In markets where missing an earnings projection by a penny can result in a loss of millions of dollars in market capitalization, I have a hard time accepting that some of these so-called non-events simply don't matter. (p. 153)

In line with this argument, several studies provide evidence that auditors were less likely to adjust detected errors or earnings management manipulations before the publication of financial statements, although the errors exceeded the materiality threshold (e.g. Wright & Wright, 1997; Braun, 2001; Nelson et al., 2005). Prior studies also reported that auditors often used a reason of immateriality as an excuse for not incorporating potential misstatements (e.g. Weinstein, 2007; Elder & Allen, 1998). Libby and Kinney (2000) found that auditors were less likely to ask for correction of misstatements that could cause earnings to fall below analysts' forecast, even though they were objectively measured. Weinstein

(2007) reported that in the case of Waste Management Corporation (WS), the auditors simply reconsidered the materiality limit when their proposed adjusting entries were rejected by the WS management, and accordingly, an unqualified audit report was issued to the company. Braun (2001) highlighted that auditors were more likely to waive the proposed adjusting entries when they knew that the litigation risks from doing so were low.

In sum, the above studies not only show that the concept of materiality was abused by the management of companies and their auditors, they also demonstrate that the assumption that companies did not disclose certain items in financial statements because the items were considered immaterial by the auditors may not necessarily be true. Prior studies on the IFRS have also raised the issue of unqualified audit reports when there was non-compliance with the IFRS. Cairns (2001) assessed a sample of 165 companies that used the IFRS in their 1999-2000 financial statements. He observed that several companies still claimed that their financial statements complied with the IFRS, although their accounting policies did not comply with the IFRS. He revealed that 29% of surveyed companies followed 'implied IFRS lite', where companies claimed to have used the IFRS but in fact had not complied fully with the IFRS. He also observed that some auditors issued unqualified audit reports for companies that did not comply with the IFRS.

Glaum and Street (2003) examined the extent of compliance with both the

International Accounting Standard (IAS) and the United States Generally Accepted Accounting Principles (US GAAP) for companies listed on the Germany New Market. They used a sample of 100 companies that applied the IFRS and 100 companies that applied the US GAAP for the year 2000. They found that the extent of compliance for companies that applied the US GAAP was significantly higher than for companies that applied the IFRS (86.6% versus 80.9%). Similar to Cairns (2001), they also observed that none of the audit reports was qualified with respect to non-compliance with IFRS or US GAAP disclosure requirements. They acknowledged that 'materiality' could be a reason for unqualified audit reports, but they argued it should not be the case when there was significant non-compliance. Glaum and Street (2003, p. 93) argued, "...there can be no serious doubt that, at least in the extreme cases where New Market firms reported less than 60% or even 50% of the required disclosure items, qualifications should have applied."

Similarly, Al-Shammiri et al. (2008) examined the extent of disclosure and measurement compliance with the IFRS in six Gulf Co-operation Council (GCC) countries and also found that auditors issued a clean audit report despite non-compliance with the IFRS. Abdullah et al. (2012) examined the extent of compliance with IFRS disclosure requirements of 225 public-listed companies in Malaysia. They found that the minimum compliance score for FRS136, FRS117, FRS119, FRS114 and

FRS2 was zero, which indicates that there were companies that did not provide any part of the information required by these standards. They also documented that a considerable number of companies have compliance scores below 70%, but none of these companies received a qualified audit opinion despite non-compliance with IFRS disclosure requirements.

## **METHODS**

A semi-structured interview was used in this study, whereby an interview guide was used to ensure important issues were covered and that the same basic questions were pursued with each interviewee. The questions used in the interview guide were open-ended questions to allow interviewees to express their views in their own words. A sample of auditors was selected from those who assumed the position of Audit Partner or Audit Manager because their vast experience in auditing and in discussions with clients would assist this study in understanding the issuance of clean audit reports in the case of non-compliance with accounting standards. Auditors from the big four and medium-size audit firms in the Klang Valley were contacted by one of the researchers. Finally, 11 auditors consisting of four from the big four firms and seven from the medium-size firms were interviewed to gauge their views regarding the issue. Each interview session lasted between 30 and 90 minutes. Each interview was recorded and subsequently transcribed verbatim for review. To address the ethical concern in the interview research, we followed

the following research protocol. First, we obtained approval from the research unit of the university before embarking on the interviews. Second, we informed the interviewees of the objectives and procedures of the study, which included their right not to answer specific questions, the anonymity and confidentiality of the interviewees and organisations they represented, how the information would be used and quoted in the study and the plan to publish the findings in journals. To guarantee anonymity and confidentiality of interviewees, their name and the organisation they represented were not disclosed in this study. Instead, they were assigned a number and letter for identification, for example, the first auditor from a medium-size firm was designated AM1 and the first auditor from a big firm was designated AB1.

## RESULTS AND DISCUSSION

To the question, “Does non-compliance with IFRS disclosure requirements warrant qualified opinion?” the responses from all interviewed auditors indicated that qualification of audit opinion is not a result of non-compliance with IFRS disclosure requirements. The typical responses of auditors regarding the issues are best illustrated with the following quotation:

*So far we have never qualified audit report because of non-compliance with accounting standards. Normally we issued qualified audit report if there is a limitation of scope. If our clients do not want*

*to disclose certain information, we look how severe the information and how material it is...we cannot qualify the audit report just because of non-disclosure issue.*

(AM7)

The responses from auditors implied that non-compliance with IFRS disclosure requirements does not lead to qualified opinion when the non-disclosure item is considered immaterial by auditors. This is consistent with the concept of materiality that disclosure is not required if the information is perceived as immaterial and does not affect users' economic decision-making. Thus, non-compliance with IFRS disclosure requirements for immaterial items does not affect the status of unqualified audit opinion.

However, it is puzzling in cases when non-compliance is material and yet the company receives an unqualified opinion as reported in prior studies (e.g. Glaum & Street, 2003). As mentioned earlier, the concept of materiality is vague and can be misused by auditors and/or preparers. This suggests that the auditors may use legal means to conform to their clients' wishes without violating the laws or rules. In other words, the auditors may use loopholes in the laws or standards to achieve their (or the clients') objective. Therefore, there is a possibility that materiality is also used as an excuse by auditors to justify the unqualified audit opinion despite material non-compliance with IFRS disclosure requirements.

In light of this, the auditors were also challenged by the findings of prior studies regarding unqualified audit reports despite significant (material) non-compliance with IFRS disclosure requirements. In response, while some auditors stated that they could not give any comment about the findings, two auditors believed that materiality could be a reason for non-qualification audit opinion. As one auditor argued:

*I think the auditors did not qualify the report may be in his opinion non-disclosure items are not material... though the rule of thumb is 5% of PBT [profit before tax]... we cannot apply one threshold to all cases. The auditors may have their own judgement about the [materiality] threshold they used... the auditors may lower or increase the threshold depending on the companies' condition.*

(AM9)

Another auditor remarked:

*I think it depends on materiality judgement. The standard said the omissions are material if they affect economic decisions of users where the users here are assumed to have reasonable knowledge of business and accounting and willing to study the information with reasonable diligence...but do you think we have these characteristics of users*

*in Malaysia?...perhaps this is an issue here... .*

(AB10)

Two inferences can be made from the above responses. The first response (AM9) suggests that the materiality concept is subjective and that there is no clear-cut materiality threshold to be used. It is, therefore, possible that certain issues may be deemed immaterial by some auditors but not others (Kranacher, 2007). In this regard, it is possible that materiality is misused or used as a reason by auditors to justify non-compliance with IFRS disclosure requirements. The second response (AB10) implies that the characteristics of users<sup>9</sup> must be considered in assessing whether or not non-disclosure items are material and affect the economic decisions of users. Given that the users of financial statements in Malaysia are perceived as passive investors, it is possible that auditors use the requirement prescribed in the standard to argue that (non-disclosure) items are immaterial and that they do not influence the economic decisions of users. In other words, the auditors may argue that (non-disclosure) items are irrelevant in the economic decision-making

<sup>9</sup>The accounting standards prescribed the users of financial statements "...are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence" (FRS101-Presentation of Financial Statements)



of Malaysian users since these users do not possess the characteristics of users as prescribed by the standard.

Nevertheless, three auditors suggested an alternative reason why material non-compliance did not lead to the qualification opinion, referring to the relief in Section 166A (4) of the Companies Act 1965 that allows companies not to comply with the accounting standards when compliance would result in misleading the true and fair view (TFV) of financial statements. Auditors' arguments regarding a TFV are illustrated below:

*Compliance with accounting standards is required by law so technically if you're not complied you will get a qualified audit report. But if you look at Companies Act 1965, there is an avenue for them [companies] that said if the compliance with accounting standards does not reflect to the true and fair view to the companies then they can depart from complying... but they can justify a lot of things why the disclosure is so unfair for them...so non-compliance will not necessarily lead to qualified audit report...*

(AB4)

*Normally we take stand on materiality whether to qualify or not...but sometimes the company did not want to disclose it because it contradicts with the company's*

*policy ... according to the rule it can be considered as non-compliance case...but in Malaysia we have another clause in the Companies Act 1965...if there is a contradiction between the company's policy and the accounting standards and leads to misleading about the company, then the Companies Act can overrule the standards. So in this case, we cannot simply give a qualified audit report.*

(AB3)

The responses by the auditors suggested that companies may opportunistically use a TFV to avoid compliance with certain accounting standards, as mentioned by auditor (AB4) above: "they can justify a lot of things why the disclosure is so unfair for them." The preparers may perhaps have had the incentive to do so because there was no clear definition of a TFV.

As mentioned earlier, though a TFV is fundamental in the preparation of financial statements, it has never been defined in law. The TFV, it is argued, depends on the professional judgement of individuals; its meaning and significance are also affected by cultural, legal and accounting attitudes and perceptions (Alexander, 1993). It is, therefore, not surprising when a TFV has been interpreted and understood differently both within a country and internationally (Evans, 2003; Aisbitt & Nobes, 2001). A different interpretation of a true and fair view among auditors and finance directors is also highlighted in the literature (e.g. Parker

& Nobes, 1991). This indicates that the TFV definition is vague and thus, provides an incentive for preparers and auditors to take opportunities to abuse the true and fair view override (Nobes, 2000; Evans, 2003). Although non-compliance with accounting standards is permitted by law to achieve a TFV presentation, it is also likely that a TFV override is misused by both preparers and auditors. In this case, the auditors may have argued that unqualified audit report was appropriate because non-compliance did not contravene the law.

## CONCLUSION

This study aimed to explore the reasons why an unqualified audit report was issued despite significant non-compliance with IFRS disclosure requirements. Overall, the interviews with auditors suggested that non-compliance with IFRS disclosure requirements does not lead to qualification of audit reports on the basis of materiality and true and fair view override. However, it is important to note that the concept of materiality and a TFV definition are both vague and can be abused or misused by preparers and auditors alike.

The indefinable nature of the TFV concept may give an avenue for preparers or auditors to argue many reasons why compliance with accounting standards would lead to misleading financial statements. Furthermore, the Companies Act 1965 also leaves the justification of TFV override to the judgement of

company directors, thus creating a wider interpretation of TFV. Hence, auditors and preparers might use the letter of the law and accounting rules to escape compliance with accounting standards without actually violating the law and rule. Alexander and Archer (2003) referred to this practice as 'creative accounting or creative compliance' where they note:

Creative accounting may involve the use of ingenious arguments to justify a departure from an accounting standard (i.e. an 'override') or 'creative compliance', which is the use of the letter of an accounting standard to disregard its 'spirit'.  
(p. 10)

To conclude, while materiality and TFV override reasonably justify the issue of unqualified audit reports despite (material) non-compliance with IFRS disclosure requirements, this study argues that both materiality and TFV override can also be used as an excuse (or misused) by preparers and auditors to justify departure from compliance with IFRS disclosure requirements without risking the status of clean audit report. In other words, the auditors and preparers may use creative compliance to avoid compliance with accounting standards while maintaining the status of unqualified (clean) audit report. Although creative compliance is not violating the law, the intention is to deliberately mislead the users of

financial statements, thus undermining the spirit of the law and accounting standards (Alexander & Archer, 2003), and this issue must be addressed by regulators, standard setters and policy-makers.

The limitations of this study are acknowledged. The samples included only 11 auditors, thus the findings may not represent the professional opinion or practice of all auditors. Further, the questions posed to auditors could only inform on the perceptions of auditors and thus, the answers provided might be biased. Any generalisation of the findings of this study must, therefore, be made with caution.

Despite these limitations, this exploratory study has provided some answers to the puzzling question raised in prior studies as to why unqualified audit reports were issued despite significant non-compliance with accounting standards. This study may be of interest to regulators, standard setters and professional accounting bodies as its findings indicate that there is a possibility that the concepts of true and fair view override and materiality might be misused by preparers and auditors to justify non-compliance with IFRS disclosure requirements without risking the status of unqualified audit report.

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