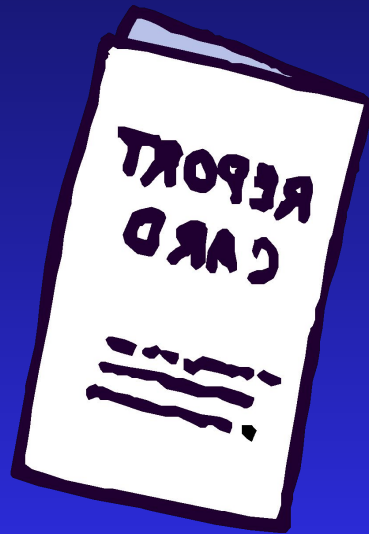


# Chapter 3

## Audit Reports



# Presentation Outline

- I. The Standard Audit Report
- II. Section 404 of the Sarbanes-Oxley Act
- III. Conditions Requiring an Explanatory Paragraph or Modified Report Wording
- IV. Other Opinion Possibilities
  - V. Scope Limitation
  - VI. GAAP Departure
  - VII. Lack of Independence
  - VIII. Other Information

# I. The Standard Audit Report

- A. The Seven Parts of the Auditor's Standard Report
- B. Five Conditions for the Standard Report

## A. The Seven Parts of the Auditor's Standard Report

- Report title – Must include the word independent.
- Audit report address – Customary to address to board of directors and stockholders to demonstrate independence.
- Introductory paragraph – States that an audit has been performed; identifies the financial statements and appropriate dates; states that the financial statements are the responsibility of the entity's management.
- Scope paragraph – States that auditor followed GAAS or PCAOB standards and indicates that the audit only provides reasonable assurance.
- Opinion paragraph – Communicates the results of the audit.
- Name of CPA firm or practitioner.
- Audit report date showing last day of field work. Auditor is held accountable only through this date

## B. Five Conditions for the Standard Report

- All 4 of the basic financial statements are included.
- Three General Standards have been followed.
- Sufficient evidence has been accumulated and three Field Work Standards have been followed.
- Financial Statements are in accordance with U.S. GAAP.
- No circumstances require an explanatory paragraph or modified wording of the report.



## II. Section 404 of the Sarbanes-Oxley Act

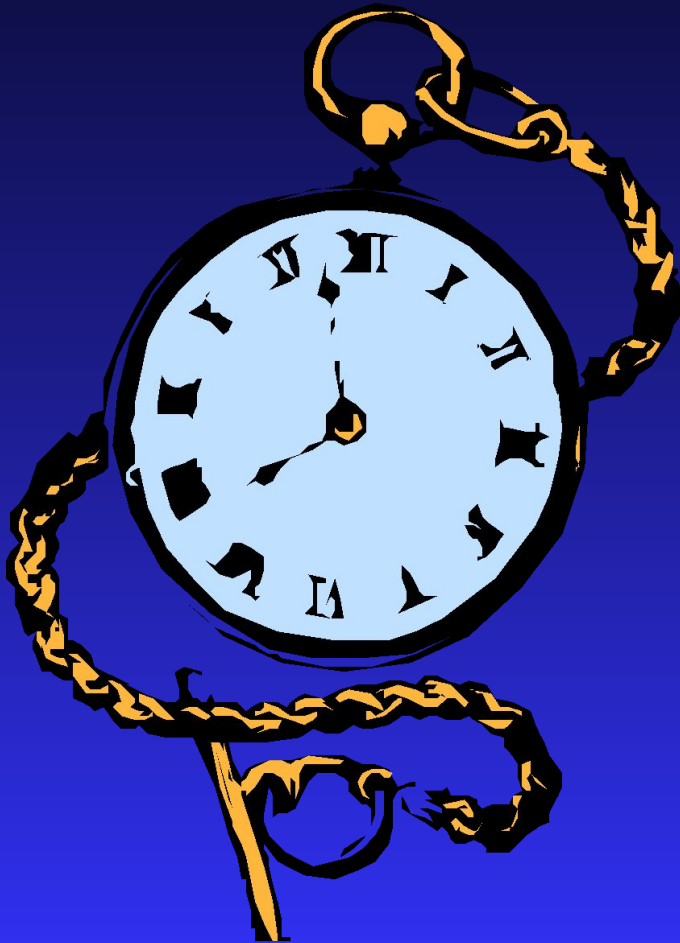


- A. PCAOB Auditing Standard 2
- B. The Time Period Covered
- C. The Audit Report

# A. PCAOB Auditing Standard 2

- Section 404 requires the auditor of a public company to attest to management's report on the effectiveness of internal control over financial reporting.
- PCOAB Auditing Standard 2 requires the audit of internal control to be integrated with the audit of the financial statements.

## B. The Time Period Covered

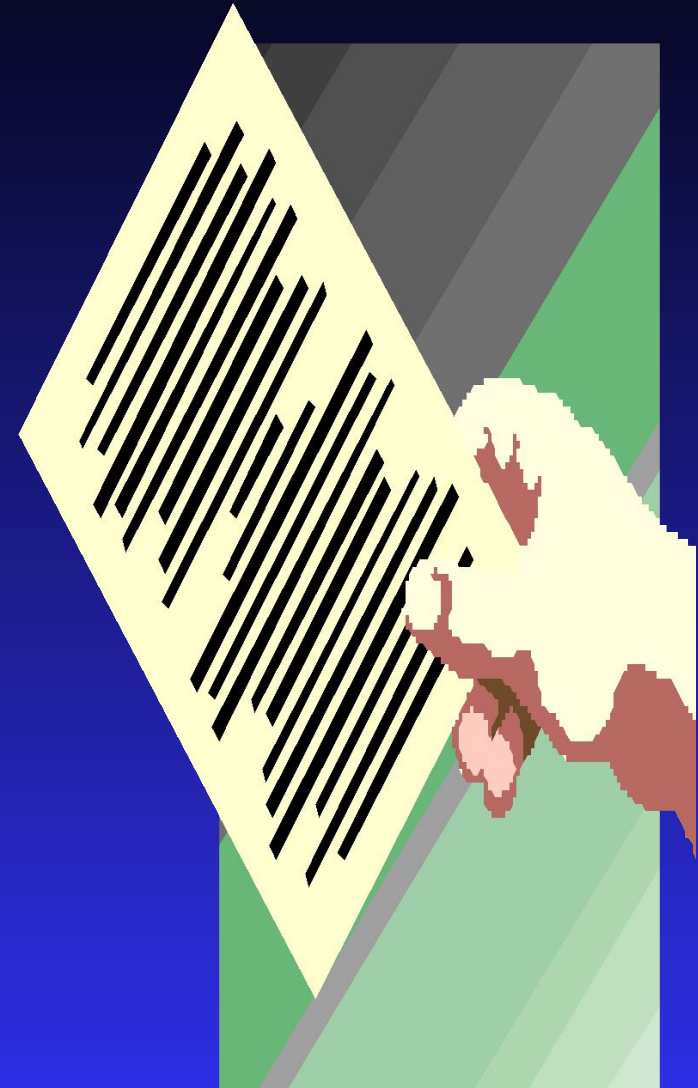


Although the audit opinion on the financial statements addresses multiple reporting periods, management's assertion about the effectiveness of internal control is as of the end of the most recent fiscal year.



# C. The Audit Report

- The auditor may choose to issue separate reports or a combined report, such as the one shown in Figure 3-3 on page 50.
- The combined report on financial statements and internal control over financial reporting addresses both the financial statements and management's report on internal control over financial reporting.



### III. Conditions Requiring an Explanatory Paragraph or Modified Report Wording

- A. Lack of Consistency
- B. Going Concern Problem
- C. Auditor Agrees with a Departure from GAAP
- D. Emphasis of a Matter
- E. Reports Involving Other Auditors

**Note: The first four reports above require an explanatory paragraph following the opinion paragraph. There is no change in the wording of the three standard paragraphs. For reports involving other auditors, the three standard report paragraphs are modified but there is not a separate explanatory paragraph.**

## A. Lack of Consistency

**The following affect consistency and require an explanatory paragraph when material (See Fig. 3-4 on page 51):**

- **Change in accounting principles (i.e., FIFO to LIFO)**
- **Change in reporting entities (i.e., change is companies in combined financial statements)**
- **Corrections of changing from unacceptable to acceptable accounting principles.**

**The following affect comparability but not consistency. If material these items may require disclosure, but not a explanatory paragraph:**

- **Change in accounting estimate (i.e., asset's depreciable life)**
- **Error correction not involving accounting (i.e., math error)**
  - **Variations in format and presentation.**
- **Changes due to substantially different events such as the sale of a subsidiary.**

## B. Going Concern Problem

- *SAS No. 59* requires auditor to evaluate going concern for a reasonable time (not over one year from date of financial statements).
- Include an explanatory paragraph that includes the phrases “substantial doubt” and “going concern.” See Figure 3-5 on page 53.



**Note: SAS No. 59 permits but does not require a disclaimer of opinion**

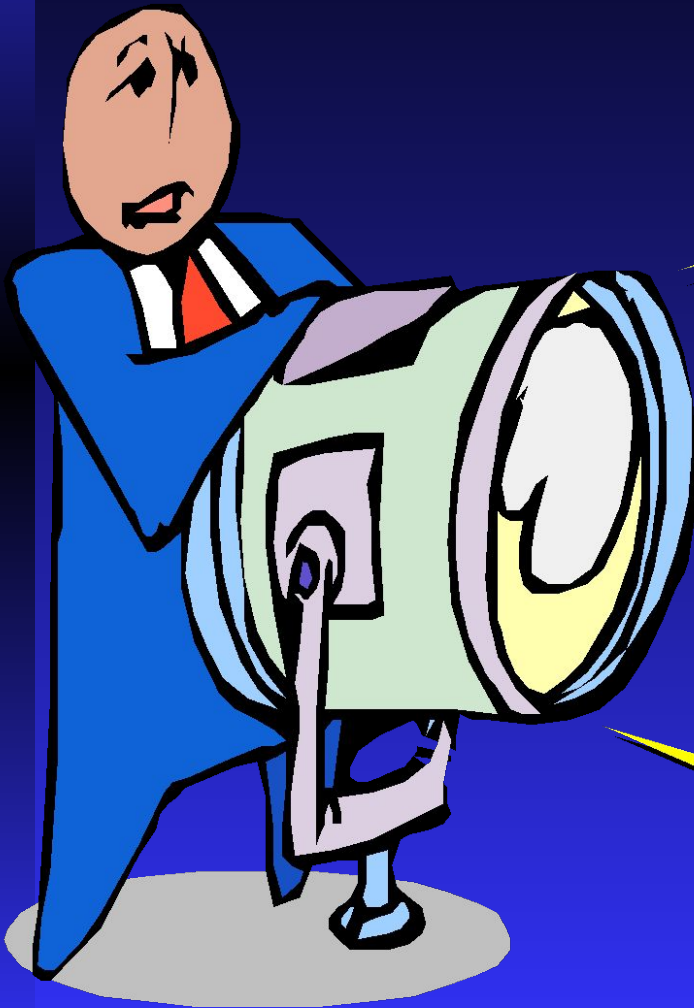
**when there is substantial doubt about ability to continue as a going concern**

## C. Auditor Agrees with a Departure from GAAP



- An auditor may issue an unqualified opinion when a departure from GAAP is necessary to prevent financials from being misleading.
- Modify report wording by adding an explanatory paragraph.

# D. Emphasis of A Matter



The auditor may add an explanatory paragraph to emphasize items such as:

- ❖ Significant related party transactions
- ❖ Important subsequent events
  - ❖ Factors affecting comparability of financial statements.
- ❖ Material uncertainties disclosed in the notes to the financial statements.

# E. Reports Involving Other Auditors

## Assume Responsibility

- If you accept responsibility for the other auditor's work (and it is unqualified) the standard report may be issued without modification.
- If the other auditors report is qualified and the qualification is material to the financial statements taken as a whole, you must qualify your report.

## Shared Responsibility

- The opinion is unaffected (i.e. can be unqualified).
- Modify all three paragraphs of the standard report (See Figure 3-6 on page 54).

## Assume No Responsibility

A qualified opinion or disclaimer, depending on materiality, is required.

# IV. Other Opinion Possibilities

- A. Qualified Opinion
- B. Adverse Opinion
- C. Disclaimer of Opinion



# A. Qualified Opinion

- Use the term “except for” in the opinion paragraph to exclude a specific item from the auditor’s opinion.
- Qualified opinion is appropriate when there is a:
  - ◆ Material scope limitation (qualified scope, additional paragraph, and qualified opinion)
  - ◆ Material departure from GAAP (additional paragraph, qualified opinion)



**Note: Materiality is defined in Table 3-1 on page 57.**

An auditor  
may have to  
play the bad  
guy to  
protect the  
public

## B. Adverse Opinion

- Financials as a whole are not fairly presented.
- Used when auditor feels that financial statements contain a highly material departure from GAAP.



**Note: Materiality is defined in Table 3-1 on page 57.**

# C. Disclaimer of Opinion

- Auditor can not express an opinion.
- Disclaimer of opinion is appropriate when:
  - ◆ There is a highly material scope limitation.
  - ◆ There is a lack of independence



**Note: Auditor has option to issue a disclaimer of opinion for a going concern problem.**

**Note: Materiality is defined in Table 3-1 on page 57.**

# V. Scope Limitation

- A. Scope Limitation Defined
- B. Effect of Scope Limitation on Audit Report – Qualified Opinion
- C. Effect of Scope Limitation on Audit Report – Disclaimer of Opinion

# A. Scope Limitation Defined

- An unqualified opinion can only be issued for an immaterial scope limitation.
- If the scope is restricted by the client, the auditor will usually disclaim an opinion.
- If scope is restricted by other conditions:
  - ◆ Qualified opinion if statements “as a whole” are not affected.
  - ◆ Disclaimer if scope limitation affects numerous financial statement items.



**Note: Materiality is defined in Table 3-1 on page 57.**

## B. Effect of Scope Limitation on Audit Report – Qualified Opinion

- Introductory paragraph is same as in standard report.
- Scope paragraph identifies limitation by adding “except as discussed in the following paragraph.”
- A separate explanatory paragraph is added to the report to describe the scope limitation.
- Opinion paragraph wording is changed to express an “except for” qualified opinion.

**Note: See Figure 3-7 on page 59.**

## C. Effect of Scope Limitation on Audit Report – Disclaimer of Opinion

- Introductory paragraph modified to say “We were engaged to audit...” rather than “We have audited ...”.
- Scope paragraph is omitted.
- A separate explanatory paragraph is added to the report to describe the scope limitation.
- Opinion paragraph wording is changed to disclaim an opinion.

**Note: See Figure 3-8 on page 60.**

## VI. GAAP Departure

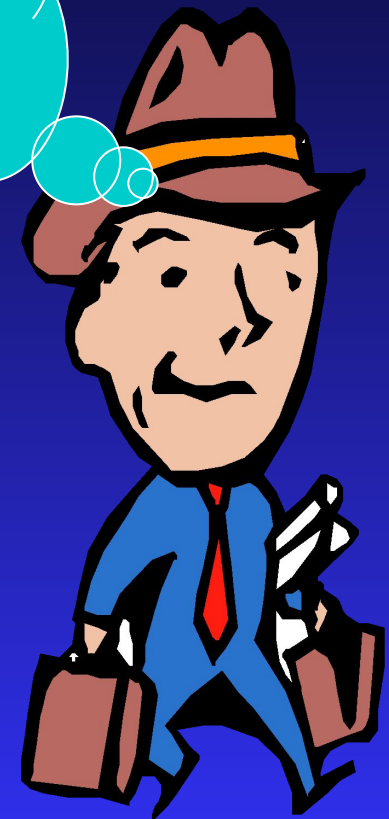
- A. GAAP Departure Defined
- B. Effect of GAAP Departure on Audit Report – Qualified Opinion
- C. Effect of Scope Limitation on Audit Report – Adverse Opinion



# A. GAAP Departure Defined

- An unqualified opinion can only be issued if GAAP departure is immaterial.
- If financial statements “taken as a whole” are not misleading, then a qualified opinion can be issued. Required for omission of statement of cash flows (SAS 58).
- If financial statements “taken as a whole” are misleading, then an adverse opinion must be issued. See Nature of Item on page 58.

How misleading are the financial statements?



**Note: Materiality is defined in Table 3-1 on page 57.**

## B. Effect of GAAP Departure on Audit Report – Qualified Opinion

- Introductory paragraph is same as in standard report.
- Scope paragraph is the same as the standard report.
- A separate explanatory paragraph is added to the report to describe the GAAP departure and its effect on the financial statements.
- Opinion paragraph wording is changed to express an “except for” qualified opinion.

**Note: See Figures 3-9 and 3-11 on pages 60-61.**

## C. Effect of GAAP Departure on Audit Report – Adverse Opinion

- Introductory paragraph is same as in standard report.
- Scope paragraph is the same as the standard report.
- Separate explanatory paragraphs are added to the report to describe the GAAP departures and their effects on the financial statements.
- Opinion paragraph wording is changed to express an adverse opinion .

**Note: See Figure 3-10 on page 61.**

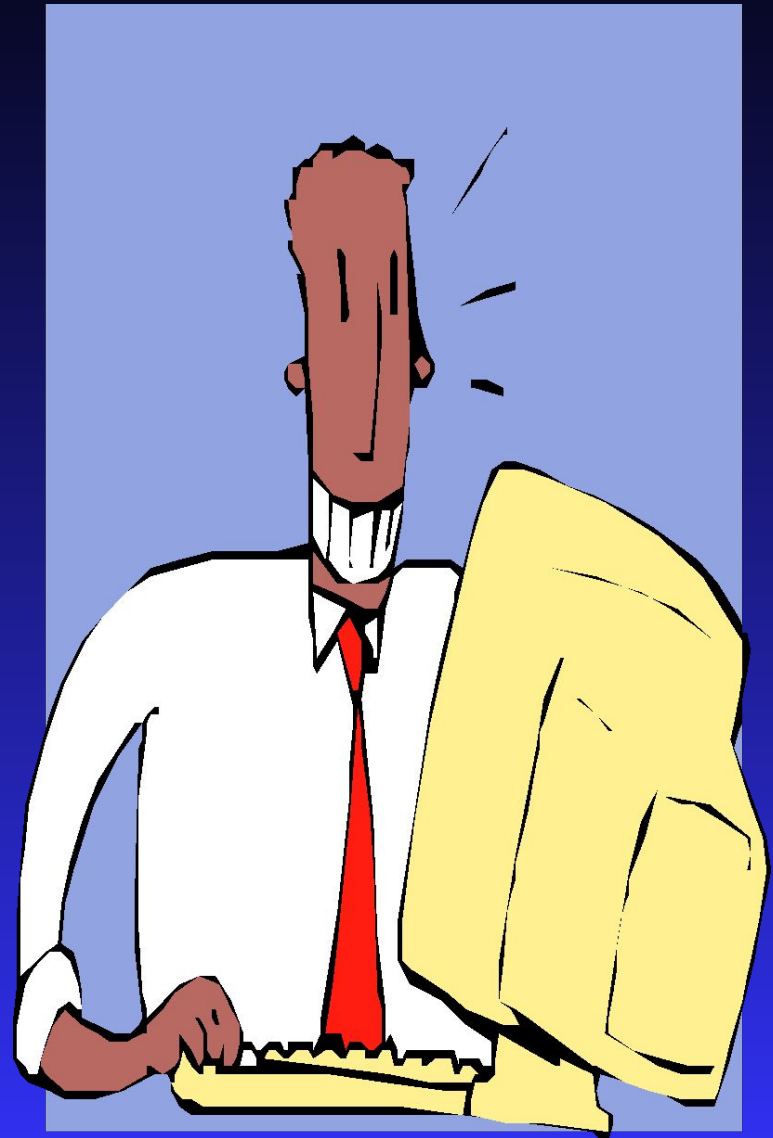
## VII. Lack of Independence



- An accountant who is not independent is required to issue a special disclaimer of opinion.
- One paragraph report with no title (See Figure 3-12 on page 61).
- No opinion is expressed.

# VIII. Other Information

- In regard to other information included with the audited financial statements in the annual report, the auditor is required to read the information to ensure that it is not materially inconsistent with the audited financial statement.
- Auditors are not currently responsible for information on a company's web site, even if it includes audited financial statements.



# Summary

|                      | Type of Report |           |                 |                 |
|----------------------|----------------|-----------|-----------------|-----------------|
| Condition            | Unqualified    | Qualified | Disclaimer      | Adverse         |
| Limit on audit scope | Immaterial     | Material  | Highly Material |                 |
| Departure from GAAP  | Immaterial     | Material  |                 | Highly Material |
| Lack of Independence |                |           | Only report     |                 |