Chapter 20-Audit Reports

The basic requirements for issuing audit reports are derived from the four GAAS for reporting. The last standard is especially important because it requires an expression of opinion about the overall financial statements or a specific statement that an overall opinion is not possible, along with the reasons for not expressing one.

Standard Unqualified Report

Your textbook and AU section 508.08 contain the standard unqualified report. I suggest that you become intimately familiar with or memorize it for your final exam. You also need to know it for the CPA exam.

This report is used when the following conditions have been met:

1–all statements are included in the financial statements

2–the 3 general standards have been followed in all respects on the engagement

3–sufficient evidence has been accumulated and the auditor has conducted the engagement in a manner that enables him to conclude that the 3 standards of field work have been met

4–the financial statements are presented in accordance with GAAP

Please be familiar with the GAAP hierarchy contained in Figure 20-1 on page 861 in your textbook.

5–there are no circumstances requiring the addition of an explanatory paragraph or modification of the wording of the report

The audit report has seven parts:

1-report title–

2–audit report address

3–introductory paragraph–this paragraph does 3 things:

1–it states that the CPA firm has done an audit

2–it lists the financial statements that were audited

3–it states that the statements are the responsibility of management and that the auditor's responsibility is to express an opinion

4–scope paragraph--

5–opinion paragraph–states the auditor's conclusions based on the results of the audit exam. The phrase "in our opinion" indicates that there may be some information risk associated with the financial statements.

What is the meaning of the term "present fairly?"

SAS 69 indicates that it means, according to the auditor's professional judgment, that the financial statements conform to GAAP with due regard for:

–the accounting principles selected and applied by the client
–the accounting principles are appropriate for the circumstances
–the financial statements are informative of matters that may affect their use and interpretation
–the information presented in the statements is summarized and presented in a reasonable manner

6–name of the CPA firm

7–audit report date--

Conditions Requiring a Departure

There are two broad categories of reports that are not standard unqualified:

1--a report that departs from an unqualified report

2--an unqualified report with an explanatory paragraph or modified wording

There are three conditions that require a departure from an unqualified report:

1–the scope of the auditor's exam has been restricted

2–the financial statements have not been prepared in accordance with GAAP

3–the auditor is not independent

Audit Reports Other than Qualified

Whenever any of the three conditions requiring a departure from an unqualified one is present, three main types of audit reports are issued:

1–adverse opinion

2–disclaimer of opinion

3–qualified opinion

Materiality

An essential consideration in determining the appropriate type of report for a given set of circumstances is materiality. If a misstatement is immaterial for both current and future periods it is OK to issue an unqualified report (e.g., expensing of all office supplies).

Three gradations of materiality are used for deciding the type of opinion to issue:

1–amounts are immaterial

2–amounts are material but do not overshadow the financial statements as a whole

3–amounts are so material or pervasive that the overall fairness of the financial statements is in question

Materiality Decisions--non-GAAP conditions

There are differences in applying materiality to the conditions requiring a departure from an unqualified opinion. Several aspects of materiality should be considered:

1–dollar amounts compared with a base

2–measurability

3–nature of the item

Materiality Decisions--scope limitations condition

The size of potential errors, where there are scope limitations, is important in determining whether an unqualified report, qualified report, or disclaimer of opinion is appropriate. It is more difficult to evaluate the materiality of potential errors resulting from scope limitations than for failure to follow GAAP.

Discussion of Conditions Requiring a Departure

Scope Restrictions

For client-imposed restrictions, the auditor should be concerned about the possibility that management is trying to prevent discovery of misstated information. The AICPA encourages a disclaimer of opinion whenever materiality is in question.

Statements Are Not in Conformity with GAAP

A qualified or adverse opinion must be issued when the auditor knows the financial statements may be misleading because they were not prepared in conformity with GAAP (depending on materiality). The opinion must state the nature of the deviation from GAAP and the amount of the misstatement.

When the client fails to include information that is necessary for the fair presentation of the financial statements in the body of the statements or in the footnotes it is the responsibility of the auditor to state the information in the audit report and issue a qualified or adverse opinion.

Rule 203 reports

Lack of statement of cash flows

Unqualified Report with an Explanatory Paragraph or Modified Wording

The following are the most important causes of the addition of an explanatory paragraph or wording modification:

Lack of consistency

The second reporting standard requires the auditor to call attention to circumstances in which GAAP have not been consistently applied in the current period in relation to the preceding period. When such changes occur, the auditor should modify the report by adding an explanatory paragraph after the opinion paragraph that discusses the nature of the change and points the reader to the footnote that discusses the change.

Changes that affect comparability but not consistency and do not need to be included in the audit report:

1--changes in estimate
2--correction of a mathematical error
3--variations in format and presentation of financial information
4--changes because of substantially different transactions or events (e.g.-sale of a subsidiary)

Items that materially affect comparability of financial statements require disclosure in footnotes.

Material Uncertainties

Sometimes an auditor encounters a situation in which the outcome of a matter cannot be reasonably estimated at the time the statements are being issued. These are called uncertainties. Examples are:

1--realizability of a significant A/R
2--litigation contingency

In 1995, the Auditing Standards Board issued SAS No. 79, which amended SAS No. 58. Before this amendment, the auditor was required to include an explanatory paragraph in an unqualified opinion in certain instances involving uncertainties. SAS No. 79 eliminates the requirement for an explanatory paragraph in such circumstances.

Substantial Doubt About Going Concern

The existence of one or more of the following factors causes uncertainty about the ability of a company to continue as a going concern:

Emphasis of a Matter

Under certain circumstances, the CPA may wish to emphasize specific matters regarding the financial statements even though he intends to express an unqualified opinion.

Such explanatory information should be included in a separate paragraph in the report.

Reports Involving Other Auditors

When the CPA firm relies upon a different CPA firm to do part of the audit, the principal CPA firm has 3 alternatives:

1–make no reference in the audit report

2–make reference in the report

3–qualify the opinion

More Than One Condition Requiring a Departure or Modification

Auditors often encounter situations involving more than one of the conditions requiring a departure from an unqualified report. The auditor should modify his opinion for each condition unless one has the effect of neutralizing the other.

Example where more than one modification should be included: