CHAPTER 3

AUDIT REPORTS

LEARNING OBJECTIVES

After studying this chapter, you should be able to

3-1 Describe the parts of the standard unqualified audit report for non-public entities under AICPA auditing standards.

3-2 Specify the conditions required to issue the standard unqualified audit report.

3-3 Understand reporting on financial statements and internal control under PCAOB auditing standards.

3-4 Describe the five circumstances when an unqualified report with an emphasis-of-matter explanatory paragraph or modified wording is appropriate.

3-5 Identify the types of audit reports that can be issued when an unqualified opinion is not justified.

3-6 Explain how materiality affects audit reporting decisions.

3-7 Draft appropriately modified audit reports under a variety of circumstances.

3-8 Determine the appropriate audit report for a given audit situation.

3-9 Understand use of international accounting and auditing standards by U.S. companies.

"Turning a Blind Eye"

Chan and Tan, a local firm, was appointed by the management of KeepItSlowSdn Berhad to replace Jonathan Broad Malaysia as its auditor. Jonathan Broad Malaysia is the Malaysian arm of a New York-based firm of CPAs. KeepItSlowSdn Berhad is the privately owned subsidiary of KeepItSlow Inc., a British Virgin Island-based technology company, which is listed on the NASDAQ.

KeepItSlowSdn Berhad hired Chan and Tan thinking that as a local firm of CPAs, it would be less critical of the findings in the audit report. Moreover, the company thought Chan and Tan would be more understanding about local accounting practices.

Jonathan Broad Malaysia resigned as the management of KeepItSlowSdn Berhad was not very happy about "the adverse"' reporting by the firm. KeepItSlowSdn Berhad was of the opinion that Jonathan Broad Malaysia was insensitive to the problems of staff turnover in the Finance Department. Within 12 months, the company had four changes to the finance director and in June all the remaining members of the Finance Department resigned. Two temporary clerks were employed in December to man the department. The CEO felt that an adverse report by the CPAs was not justifiable.

Stock taking was not performed as there were no proper inventory records. The fixed assets register had not been updated since the second finance director left. The payment vouchers for transactions between April and June were missing. The ledgers were only updated up to February. The CEO felt that all these items are immaterial to KeepItSlowInc as a whole as KeepItSlowSdn Berhad is just a tiny subsidiary of KeepItSlowInc. The auditors should not have the "audacity to question at times of difficulty." "What is a RM10 million company to a US$40 billion conglomerate?!", thought the CEO.

However, Jonathan Broad Malaysia felt that it could not "turn a blind eye" and wait until the next year when things have settled to give a more positive report. "Chan and Tan should be more sensitive to local needs as the local accounting standards are different from the U.S. standards," said the CEO. The CEO did not realise that Chan and Tan cannot be less stringent than Jonathan Broad Malaysia. Whether the CPA is local or international, Chan and Tan, or even Jonathan Broad Malaysia, have to make sure that the design, implementation, and maintenance of internal control, relevant to the preparation and fair presentation of financial statements of KeepItSlowSdn Berhad, are free from material misstatement, whether due to fraud or error.

Reports are essential to audit and assurance engagements because they communicate the auditor's findings. Users of financial statements rely on the auditor's report to provide assurance on the company's financial statements. As the story at the beginning of this chapter illustrates, the auditor will likely be held responsible if an incorrect audit report is issued.

The audit report is the final step in the entire audit process. The reason for studying it now is to permit reference to different audit reports as we study the accumulation of audit evidence throughout this text. These evidence concepts are more meaningful after you understand the form and content of the final product of the audit. We begin by describing the content of the standard auditor's report.

As discussed in Chapter 2, the AICPA Auditing Standard Board (ASB) sets standards for non-public entities, and the PCAOB sets auditing standards for public companies. Because the PCAOB adopted the existing AICPA standards as interim standards, auditing standards, including those related to audit reporting, were similar for public companies and non-public entities. However, as part of the AICPA Clarity Project, the ASB modified audit reporting for non-public entities to be similar to reporting under international auditing standards. As a result, the formats of audit reports for public and non-public entities currently differ, although the overall substance of the content in the report is similar under both AICPA and PCAOB auditing standards.

STANDARD UNQUALIFIED AUDIT REPORT FOR NON-PUBLIC ENTITIES

To allow users to understand audit reports, AICPA auditing standards provide uniform wording for the auditor's report, as illustrated in the auditor's standard unqualified audit report in Figure 3-1. Different auditors may alter the wording or presentation slightly, but the meaning will be the same.

Parts of Standard Unqualified Audit Report

OBJECTIVE 3-1

Describe the parts of the standard unqualified audit report for non-public entities under AICPA auditing standards.

The auditor's **standard unqualified audit report** contains eight distinct parts, and these are labeled in bold letters in the margin beside Figure 3-1.

1. *Report title.* Auditing standards require that the report be titled and that the title include the word *independent*. For example, appropriate titles include "independent auditor's report," "report of independent auditor," or "independent accountant's opinion." The requirement that the title include the word *independent* conveys to users that the audit was unbiased in all aspects.

2. *Audit report address.* The report is usually addressed to the company, its stockholders, or the board of directors. In recent years, it has become customary to address the report to the board of directors and stockholders to indicate that the auditor is independent of the company.

3. *Introductory paragraph.* The first paragraph of the report indicates that the CPA firm has performed an audit, which distinguishes the report from a compilation or review report. The first paragraph also lists the financial statements that were audited, including the notes to the financial statements as well as the balance sheet dates and the accounting periods for the income statement and statement of cash flows. The wording of the financial statements in the report should be identical to those used by management on the financial statements. Notice that the report in Figure 3-1 is on comparative financial statements. Therefore, a report on both years' statements is needed.

4. *Management's responsibility.* This heading and paragraph state that the statements are the responsibility of management. This responsibility includes selecting the appropriate accounting principles and maintaining internal control over financial reporting sufficient for preparation of financial statements that are free of material misstatements due to fraud or error.

5. *Auditor's responsibility.* The section on the auditor's responsibility contains three paragraphs.

The first paragraph states that the audit was conducted in accordance with auditing standards generally accepted in the United States of America. This paragraph also notes that the audit is designed to obtain *reasonable assurance* about whether

FIGURE 3-1 **Standard Unqualified Report on Comparative Statements for a U.S. Non-Public Company—AICPA Auditing Standards**

ANDERSON and ZINDER, P.C. **Certified Public Accountants** **Park Plaza East – Suite 100** **Denver, Colorado 80110** **303/359-0800**	
INDEPENDENT AUDITOR'S REPORT	**Report Title**
To the Stockholders General Ring Corporation	**Audit Report Address**
We have audited the accompanying balance sheets of General Ring Corporation as of December 31, 2013 and 2012, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.	**Introductory Paragraph**
Management's Responsibility for the Financial Statements Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.	**Management's Responsibility**
Auditor's Responsibility Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.	**Auditor's Responsibility**
An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.	***Scope paragraph***
Opinion In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of General Ring Corporation as of December 31, 2013 and 2012, and the results of their operations and cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.	**Auditor's Opinion**
Anderson and Zinder, P.C., CPAs Denver, Colorado	**Name and Address of CPA Firm**
February 15, 2014	**Audit Report Date (Date Audit Field Work Is Completed)**

the financial statements are free of **material misstatement**. The inclusion of the word *material* conveys that auditors are only responsible to search for significant misstatements, not minor misstatements that do not affect users' decisions. The use of the term *reasonable assurance* is intended to indicate that an audit cannot be expected to completely eliminate the possibility that a material misstatement will exist in the

PCAOB PROPOSES DISCLOSING ENGAGEMENT PARTNER NAME IN AUDIT REPORT

While some countries in continental Europe had already required that the personal signature of the engagement partner be included in the audit report, the passage of The European Union's Eighth Company Law Directive in 2006 made it mandatory for all EU member states. The 2008 final report of the U.S. Department of Treasury's Advisory Committee on the Auditing Profession urged the PCAOB to consider mandating the engagement partner's signature on the auditor's report. In 2009 the PCAOB issued and received comments on "Concept Release on Requiring the Engagement Partner to Sign the Audit Report."

Proponents argue that the requirement would increase the partner's sense of accountability to users and it would increase transparency about who is responsible for performing the audit. Opponents note that only including the audit firm signature signals to users that the entire audit firm stands behind the opinion. After consideration, the PCAOB did not propose a requirement to have the engagement partner personally sign the audit report. Instead, in October 2011 the PCAOB proposed to disclose the name of the engagement partner in the audit report.

Sources: 1. "Concept Release on Requiring the Engagement Partner to Sign the Audit Report," PCAOB Release No. 2009-005, July 28, 2009, PCAOB Rulemaking Docket Matter No. 29 (www.pcaobus.org); 2. "PCAOB Proposes Amendments to Improve Transparency Through Disclosure of Engagement Partner and Certain Other Participants in Audit," PCAOB News Release October 11, 2011 (www.pcaobus.org).

financial statements. In other words, an audit provides a high level of assurance, but it is not a guarantee.

The second paragraph describes the scope of the audit and the evidence accumulated. This paragraph indicates that the procedures depend on the auditor's judgment and include an assessment of the risk of material misstatements in the financial statements. It also indicates that the auditor considers internal control relevant to the preparation and fair presentation of the financial statements in designing the audit procedures performed, but this assessment of internal control is not for the purpose and is not sufficient to express an opinion on the effectiveness of the entity's internal control. The last sentence of this paragraph indicates that the audit includes evaluating the accounting policies selected, the reasonableness of accounting estimates, and the overall financial statement presentation.

The third paragraph indicates the auditor believes that sufficient appropriate evidence has been obtained to support the auditor's opinion.

6. *Opinion paragraph.* The final paragraph in the standard report states the auditor's conclusions based on the results of the audit. This part of the report is so important that often the entire audit report is referred to simply as the *auditor's opinion*. The opinion paragraph is stated as an opinion rather than as a statement of absolute fact or a guarantee. The intent is to indicate that the conclusions are based on professional judgment. The phrase *in our opinion* indicates that there may be some information risk associated with the financial statements, even though the statements have been audited.

A controversial part of the auditor's report is the meaning of the term *present fairly*. Does this mean that if generally accepted accounting principles are followed, the financial statements are presented fairly, or something more? Occasionally, the courts have concluded that auditors are responsible for looking beyond generally accepted accounting principles to determine whether users might be misled, even if those principles are followed. Most auditors believe that financial statements are "presented fairly" when the statements are in accordance with generally accepted accounting principles, but that it is also necessary to examine the substance of transactions and balances for possible misinformation.

7. *Name and address of CPA firm.* The name identifies the CPA firm or practitioner who performed the audit. Typically, the firm's name is used because the entire CPA firm has the legal and professional responsibility to ensure that the quality of the audit meets professional standards. The city and state of the audit firm should also be indicated.

8. *Audit report date.* The appropriate date for the report is the one on which the auditor completed the auditing procedures in the field. This date is important to users

because it indicates the last day of the auditor's responsibility for the review of significant events that occurred after the date of the financial statements. In the audit report in Figure 3-1 (p. 69), the balance sheet is dated December 31, 2013, and the audit report is dated February 15, 2014. This indicates that the auditor has searched for material unrecorded transactions and events that occurred up to February 15, 2014.

Conditions for Standard Unqualified Audit Report

OBJECTIVE 3-2

Specify the conditions required to issue the standard unqualified audit report.

The standard unqualified audit report is issued when the following conditions have been met:

1. All statements—balance sheet, income statement, statement of changes in stockholders' equity, and statement of cash flows—are included in the financial statements.
2. Sufficient appropriate evidence has been accumulated, and the auditor has conducted the engagement in a manner that enables him or her to conclude that the audit was performed in accordance with auditing standards.
3. The financial statements are presented in accordance with U.S. generally accepted accounting principles or other appropriate accounting framework. This also means that adequate disclosures have been included in the footnotes and other parts of the financial statements.
4. There are no circumstances requiring the addition of an explanatory paragraph or modification of the wording of the report.

When these conditions are met, the standard unqualified audit report for an audit of a non-public company, as shown in Figure 3-1, is issued. The standard unqualified audit report is sometimes called a clean opinion because there are no circumstances requiring a qualification or modification of the auditor's opinion. The standard unqualified report is the most common audit opinion. Sometimes circumstances beyond the client's or auditor's control prevent the issuance of a clean opinion. However, in most cases, companies make the appropriate changes to their accounting records to avoid a qualification or modification by the auditor.

If any of the requirements for the standard unqualified audit report are not met, the standard unqualified report cannot be issued. Figure 3-2 indicates the categories of audit reports that can be issued by the auditor. The departures from a standard

FIGURE 3-2 **Four Categories of Audit Reports**

Standard Unqualified	The four conditions stated above have been met.
Unqualified with Emphasis-of-matter Explanatory Paragraph or Modified Wording	A complete audit took place with satisfactory results and financial statements that are fairly presented, but the auditor believes that it is important or is required to provide additional information.
Qualified	The auditor concludes that the overall financial statements are fairly presented, but the scope of the audit has been materially restricted or applicable accounting standards were not followed in preparing the financial statements.
Adverse or Disclaimer	The auditor concludes that the financial statements are not fairly presented (adverse), he or she is unable to form an opinion as to whether the financial statements are fairly presented (disclaimer), or he or she is not independent (disclaimer).

unqualified report are considered increasingly severe as one moves down the figure. Financial statement users are normally much more concerned about a disclaimer or adverse opinion than an unqualified report with an explanatory paragraph. These other categories of audit reports are discussed in following sections.

UNQUALIFIED AUDIT REPORT AND REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING UNDER PCAOB AUDITING STANDARDS

OBJECTIVE 3-3

Understand reporting on financial statements and internal control under PCAOB auditing standards.

There are two significant audit reporting differences for public companies. First, the standard unqualified audit report is different for audits of financial statements of public companies. Second, auditors of larger public companies must also issue an opinion on internal control over financial reporting.

Standard Unqualified Audit Report for Public Companies

The standard unqualified audit report for public companies includes three paragraphs as illustrated in Figure 3-3. The report title, address, CPA firm name, and audit report date are similar for public companies and non-public entities and are not included in Figure 3-3. The report is quite similar to the audit report for non-public entities in Figure 3-1, with some differences in wording.

The first paragraph is the *introductory paragraph* and indicates that an audit was performed and the financial statements that were audited. The introductory paragraph also indicates that the financial statements are the responsibility of management and that the auditor's responsibility is to express an opinion on the financial statements. Note that this information is similar to the first three paragraphs in the standard unqualified report for non-public entities in Figure 3-1.

The *scope paragraph* is similar to the second paragraph under the auditor's responsibilities in Figure 3-1, and indicates that an audit is designed to provide reasonable assurance that the financial statements are free of material misstatement. The scope paragraph notes that auditing is done on a test basis.

The third paragraph is the *opinion paragraph* and is similar to the opinion paragraph included in Figure 3-1. If the auditor also issues a separate report on internal control over financial reporting, a fourth paragraph would follow the opinion paragraph referencing the audit report on internal control.

FIGURE 3-3 **Standard Unqualified Report on Comparative Statements for a U.S. Public Company – PCAOB Auditing Standards**

Introductory Paragraph	We have audited the accompanying balance sheets of Westbrook Company, Inc., as of December 31, 2013 and 2012, and the related statements of operations, equity, and cash flows for each of the three years in the period ended December 31, 2013. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audits.
Scope Paragraph	We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
Opinion Paragraph	In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Westbrook Company, Inc., as of December 31, 2013 and 2012, and the results of its operations and cash flows for each of the three years in the period ended December 31, 2013, in conformity with accounting principles generally accepted in the United States of America.

Reports on Internal Control Over Financial Reporting

As discussed in Chapter 1, Section 404(b) of the Sarbanes–Oxley Act requires the auditor of a public company to attest to management's report on the effectiveness of internal control over financial reporting. Since 2004, larger public companies (known as accelerated filers) have been required by the SEC to annually obtain an auditor's report on internal controls over financial reporting. As noted in Chapter 1, non-accelerated filers have been exempt from this requirement and the passage by Congress of the 2010 Dodd-Frank financial reform legislation made that exemption permanent for non-accelerated filers.

PCAOB Auditing Standard 5 requires the audit of internal control to be integrated with the audit of the financial statements. However, the auditor may choose to issue separate reports, such as the **separate report on internal control over financial reporting** shown in Figure 3-4, or in a combined report. 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

FIGURE 3-4 **Separate Report on Internal Control over Financial Reporting for a U.S. Public Company**

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM To the Board of Directors and Shareholders of Westbrook Company, Inc.:	
We have audited Westbrook Company, Inc.'s internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Westbrook Company, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.	**Introductory Paragraph**
We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.	**Scope Paragraph**
A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.	**Definition Paragraph**
Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.	**Inherent Limitations Paragraph**
In our opinion, Westbrook Company, Inc., maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on the COSO criteria.	**Opinion Paragraph**
We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Westbrook Company, Inc., as of December 31, 2013 and 2012, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2013, of Westbrook Company, Inc., and our report dated February 11, 2014, expressed an unqualified opinion thereon.	**Cross Reference Paragraph**

reporting. While the combined report is permitted, the separate report on internal control over financial reporting is more common and includes these elements:

- The introductory, scope, and opinion paragraphs describe that the scope of the auditor's work and opinion is on internal control over financial reporting, and the introductory paragraph highlights management's responsibility for and its separate assessment of internal control over financial reporting.
- The introductory and opinion paragraphs also refer to the framework used to evaluate internal control.
- The report includes a paragraph after the scope paragraph defining internal control over financial reporting.
- The report also includes an additional paragraph before the opinion that addresses the inherent limitations of internal control.
- Although the audit opinion on the financial statements addresses multiple reporting periods, the auditor's opinion about the effectiveness of internal control is as of the end of the most recent fiscal year.
- The last paragraph of the report includes a cross-reference to the auditor's separate report on the financial statements.

The separate report in Figure 3-4 (p. 73) is an unqualified opinion on the effectiveness of internal control over financial reporting prepared in accordance with PCAOB Auditing Standard 5. The auditor may issue a qualified opinion, adverse opinion, or disclaimer of opinion on the operating effectiveness of internal control over financial reporting. Conditions that require the auditor to issue a report other than an unqualified opinion on the operating effectiveness of internal control are discussed in Chapter 10, along with the effects of these conditions on the wording of the auditor's report on internal control over financial reporting.

Auditor reporting on internal controls for private companies is covered in Chapter 25.

UNQUALIFIED AUDIT REPORT WITH EMPHASIS-OF-MATTER EXPLANATORY PARAGRAPH OR MODIFIED WORDING

OBJECTIVE 3-4

Describe the five circumstances when an unqualified report with an emphasis-of-matter explanatory paragraph or modified wording is appropriate.

The remainder of this chapter deals with reports, other than standard unqualified reports, on the audit of financial statements. In certain situations, an unqualified audit report on the financial statements is issued, but the wording deviates from the standard unqualified report. The **unqualified audit report with explanatory paragraph or modified wording** meets the criteria of a complete audit with satisfactory results and financial statements that are fairly presented, but the auditor believes it is important or is required to provide additional information. In a qualified, adverse, or disclaimer report, the auditor either has not performed a satisfactory audit, is not satisfied that the financial statements are fairly presented, or is not independent.

The following are the most important causes of the addition of an explanatory paragraph or a modification in the wording of the standard unqualified report under both AICPA and PCAOB audit standards:

- Lack of consistent application of generally accepted accounting principles
- Substantial doubt about going concern
- Auditor agrees with a departure from promulgated accounting principles
- Emphasis of other matters
- Reports involving other auditors

Only reports involving other auditors use modified wording. The first four reports all require an explanatory paragraph. In each case, the standard report paragraphs

FIGURE 3-5	Explanatory Paragraph Because of Change in Accounting Principle
INDEPENDENT AUDITOR'S REPORT *(Same paragraphs as the standard report)* As discussed in Note 8 to the financial statements, the Company changed its method of computing depreciation in 2013. Our opinion is not modified with respect to this matter.	**Added Explanatory Paragraph**

are included without modification, and a separate explanatory paragraph follows the opinion paragraph.

The term "explanatory paragraph" was replaced in the AICPA auditing standards with "emphasis-of-matter" or "other-matter" paragraphs. If reporting on a non-public entity under AICPA auditing standards, the explanatory paragraph should be preceded by the header "Emphasis of a Matter." Note that this heading is used for the first three types of explanatory paragraphs as well as other matters that the auditor wishes to emphasize. These paragraphs continue to be referred to as explanatory paragraphs under PCAOB auditing standards. We refer to them as explanatory paragraphs in this chapter.

Lack of Consistent Application of GAAP

Auditing standards require the auditor to call attention to circumstances in which accounting principles have not been consistently observed in the current period in relation to the preceding period. Generally accepted accounting principles require that changes in accounting principles or their method of application be to a preferable principle and that the nature and impact of the change be adequately disclosed. When a material change occurs, 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. The materiality of a change is evaluated based on the current year effect of the change. An explanatory paragraph is required for both voluntary changes and required changes due to a new accounting pronouncement. Figure 3-5 presents such an explanatory paragraph.

It is implicit in the explanatory paragraph in Figure 3-5 that the auditor concurs with the appropriateness of the change in accounting principles. If the auditor does not concur, the change is a violation of generally accepted accounting principles and the auditor's opinion must be qualified.

Consistency Versus Comparability The auditor must be able to distinguish between changes that affect consistency and those that may affect comparability but do not affect consistency. The following are examples of changes that affect consistency and therefore require an explanatory paragraph if they are material:

1. Changes in accounting principles, such as a change from FIFO to LIFO inventory valuation
2. Changes in reporting entities, such as the inclusion of an additional company in combined financial statements
3. Corrections of errors involving principles, by changing from an accounting principle that is not generally acceptable to one that is generally acceptable, including correction of the resulting error

Changes that affect comparability but not consistency and therefore need not be included in the audit report include the following:

1. Changes in an estimate, such as a decrease in the life of an asset for depreciation purposes

FIGURE 3-6	Explanatory Paragraph Because of Substantial Doubt About Going Concern
	INDEPENDENT AUDITOR'S REPORT *(Same paragraphs as the standard report)*
Added Explanatory Paragraph	The accompanying financial statements have been prepared assuming that Fairfax Company will continue as a going concern. As discussed in Note 11 to the financial statements, Fairfax Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about the company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 11. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

2. Error corrections not involving principles, such as a previous year's mathematical error
3. Variations in format and presentation of financial information
4. Changes because of substantially different transactions or events, such as new endeavors in research and development or the sale of a subsidiary

Items that materially affect the comparability of financial statements generally require disclosure in the footnotes. A qualified audit report for inadequate disclosure may be required if the client refuses to properly disclose the items.

Substantial Doubt About Going Concern

Even though the purpose of an audit is not to evaluate the financial health of the business, the auditor has a responsibility under auditing standards to evaluate whether the company is likely to continue as a going concern. For example, the existence of one or more of the following factors causes uncertainty about the ability of a company to continue as a going concern:

1. Significant recurring operating losses or working capital deficiencies
2. Inability of the company to pay its obligations as they come due
3. Loss of major customers, the occurrence of uninsured catastrophes such as an earthquake or flood, or unusual labor difficulties
4. Legal proceedings, legislation, or similar matters that have occurred that might jeopardize the entity's ability to operate

The auditor's concern in such situations is the possibility that the client may not be able to continue its operations or meet its obligations for a reasonable period. For this purpose, a reasonable period is considered not to exceed 1 year from the date of the financial statements being audited.

When the auditor concludes that there is substantial doubt about the entity's ability to continue as a going concern, an unqualified opinion with an explanatory paragraph is required, regardless of the disclosures in the financial statements. Figure 3-6 provides an example in which there is substantial doubt about going concern.

Auditing standards permit but do not require a disclaimer of opinion when there is substantial doubt about going concern. The criteria for issuing a disclaimer of opinion instead of adding an explanatory paragraph are not stated in the standards, and this type of opinion is rarely issued in practice. An example for which a disclaimer might be issued is when a regulatory agency, such as the Environmental Protection Agency, is considering a severe sanction against a company and, if the proceedings result in an unfavorable outcome, the company will be forced to liquidate.

Auditor Agrees with a Departure from a Promulgated Principle

Rule 203 of the AICPA *Code of Professional Conduct* states that in unusual situations, a departure from a generally accepted accounting principle may not require a qualified or adverse opinion. However, to justify an unqualified opinion, the auditor must be satisfied and must state and explain, in a separate paragraph or paragraphs in the audit report, that adhering to the principle would produce a misleading result in that situation.

Emphasis of Other Matters

Under certain circumstances, the CPA may want to emphasize specific matters regarding the financial statements, even though he or she intends to express an unqualified opinion. Normally, such explanatory information should be included in a separate paragraph in the report. Examples of explanatory information the auditor may report as an emphasis of a matter include the following:

- The existence of material related party transactions
- Important events occurring subsequent to the balance sheet date
- The description of accounting matters affecting the comparability of the financial statements with those of the preceding year
- Material uncertainties disclosed in the footnotes

Reports Involving Other Auditors

CPAs often rely on a different CPA firm to perform part of the audit when the client has widespread operations. The primary auditor issuing the opinion on the financial statements is called the *principal auditor* under PCAOB auditing standards and the *group engagement partner* under AICPA auditing standards. The other auditor who performs work on the financial information of a component is called the *component auditor* under AICPA auditing standards. When the CPA relies on a different CPA firm to perform part of the audit, the principal CPA firm has three alternatives. Only the second is an unqualified report with modified wording.

1. Make No Reference in the Audit Report When no reference is made to the other auditor, a standard unqualified opinion is given unless other circumstances require a departure. This approach is typically followed when the other auditor audited an immaterial portion of the statements, the other auditor is well known or closely supervised by the principal auditor, or the principal auditor has thoroughly reviewed the other auditor's work. The other auditor is still responsible for his or her own report and work in the event of a lawsuit or SEC action.

FIGURE 3-7 **Unqualified Shared Report – AICPA Auditing Standards**

INDEPENDENT AUDITOR'S REPORT

(Same introductory and management's responsibility paragraphs as the standard report)

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of Stewart Pane and Lighting, a wholly-owned subsidiary, which statements reflect total assets constituting 20 percent and 22 percent, respectively, of consolidated total assets at December 31, 2013 and 2012, and total revenues constituting 18 percent and 20 percent, respectively, of consolidated total revenues for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for Stewart Pane and Lighting, is based solely on the report of the other auditors. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

(Same scope paragraph under auditor's responsibility as the standard report)

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, based on our audit and the report of the other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of Washington Felp Corporation as of December 31, 2013 and 2012, and the results of their operations and cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

2. Make Reference in the Report (Modified Wording Report) This type of report is called a shared opinion or report. A shared unqualified report is appropriate when the portion of the financial statements audited by the other CPA is material in relation to the whole. An example of an unqualified shared report for a non-public company is shown in Figure 3-7 (p. 77). Notice that the report does not include a separate paragraph that discusses the shared responsibility, but does so in the auditor's responsibility and opinion paragraphs. The portions of the financial statements audited by the other auditor can be stated as percentages or absolute amounts.

3. Qualify the Opinion A qualified opinion or disclaimer, depending on materiality, is required if the principal auditor is not willing to assume any responsibility for the work of the other auditor. The principal auditor may also decide that a qualification is required in the overall report if the other auditor qualified his or her portion of the audit. Qualified opinions and disclaimers are discussed in a later section.

DEPARTURES FROM AN UNQUALIFIED AUDIT REPORT

OBJECTIVE 3-5

Identify the types of audit reports that can be issued when an unqualified opinion is not justified.

It is essential that auditors and readers of audit reports understand the circumstances when an unqualified report is inappropriate and the type of audit report issued in each circumstance. In the study of audit reports that depart from an unqualified report, there are three closely related topics: the conditions requiring a departure from an unqualified opinion, the types of opinions other than unqualified, and materiality.

First, the three conditions requiring a departure are briefly summarized. Each is discussed in greater depth later in the chapter.

1. The Scope of the Audit Has Been Restricted (Scope Limitation) When the auditor has not accumulated sufficient appropriate evidence to conclude whether financial statements are stated in accordance with the appropriate financial reporting framework, a scope restriction exists. There are two major causes of scope restrictions: restrictions imposed by the client and those caused by circumstances beyond either the client's or auditor's control. An example of a client restriction is management's refusal to permit the auditor to confirm material receivables or to physically examine inventory. An example of a restriction caused by circumstances is when the auditor is not appointed until after the client's year-end. It may not be possible to physically observe inventories, confirm receivables, or perform other important procedures after the balance sheet date.

2. The Financial Statements Have Not Been Prepared in Accordance with Generally Accepted Accounting Principles (GAAP Departure) For example, if the client insists on using replacement costs for fixed assets or values inventory at selling price rather than historical cost as required by generally accepted accounting principles, a departure from the unqualified report is required. When U.S. generally accepted accounting principles or international financial reporting standards (IFRS) are referred to in this context, consideration of the adequacy of all informative disclosures, including footnotes, is especially important. While most U.S. companies prepare their financial statements in accordance with GAAP, some entities might use other financial reporting frameworks, such as IFRS. References to GAAP in this chapter also apply to situations where the client has selected another appropriate financial reporting framework.

3. The Auditor Is Not Independent Independence ordinarily is determined by Rule 101 of the rules of the *Code of Professional Conduct.* Auditor independence requirements and the *Code of Professional Conduct* are further discussed in Chapter 5.

When any of the three conditions requiring a departure from an unqualified report exists and is material, a report other than an unqualified report must be issued.

Three main types of audit reports are issued under these conditions: qualified opinion, adverse opinion, and disclaimer of opinion.

Qualified Opinion

A **qualified opinion** report can result from a limitation on the scope of the audit or failure to follow generally accepted accounting principles. A qualified opinion report can be used *only when the auditor concludes that the overall financial statements are fairly stated.* A disclaimer or an adverse report must be used if the auditor believes that the condition being reported on is highly material. Therefore, the qualified opinion is considered the least severe type of departure from an unqualified report.

A qualified report can take the form of a *qualification of both the scope and the opinion* or of the *opinion alone.* A scope and opinion qualification can be issued only when the auditor has been unable to accumulate all of the evidence required by auditing standards. Therefore, this type of qualification is used when the auditor's scope has been restricted by the client or when circumstances exist that prevent the auditor from conducting a complete audit. The use of a qualification of the opinion alone is restricted to situations in which the financial statements are not stated in accordance with GAAP.

When an auditor issues a qualified report, he or she must use the term *except for* in the opinion paragraph. The implication is that the auditor is satisfied that the overall financial statements are correctly stated "except for" a specific aspect of them. Examples of this qualification are given later in this chapter. It is unacceptable to use the phrase *except for* with any other type of audit opinion.

Adverse Opinion

An **adverse opinion** is used only when the auditor believes that the overall financial statements are so *materially misstated or misleading* that they do not present fairly the financial position or results of operations and cash flows in conformity with GAAP. The adverse opinion report can arise only when the auditor has knowledge, after an adequate investigation, of the absence of conformity. This is uncommon and thus the adverse opinion is rarely used.

Disclaimer of Opinion

A **disclaimer of opinion** is issued when the auditor has been *unable to satisfy himself or herself* that the overall financial statements are fairly presented. The necessity for disclaiming an opinion may arise because of a *severe limitation on the scope* of the audit or a *nonindependent relationship* under the *Code of Professional Conduct* between the auditor and the client. Either of these situations prevents the auditor from expressing an opinion on the financial statements as a whole. The auditor also has the option to issue a disclaimer of opinion for a going concern problem.

The disclaimer is distinguished from an adverse opinion in that it can arise only from a *lack of knowledge* by the auditor, whereas to express an adverse opinion, the auditor must have knowledge that the financial statements are not fairly stated. Both disclaimers and adverse opinions are used only when the condition is highly material.

MATERIALITY

OBJECTIVE 3-6

Explain how materiality affects audit reporting decisions.

Materiality is an essential consideration in determining the appropriate type of report for a given set of circumstances. For example, if a misstatement is immaterial relative to the financial statements of the entity for the current period, it is appropriate to issue an unqualified report. A common instance is the immediate expensing of office supplies rather than carrying the unused portion in inventory because the amount is insignificant.

The situation is totally different when the amounts are of such significance that the financial statements are materially affected as a whole. In these circumstances, it is necessary to issue a disclaimer of opinion or an adverse opinion, depending on whether a scope limitation or GAAP departure is involved. In situations of lesser materiality, a qualified opinion is appropriate.

Levels of Materiality

The common definition of materiality as it applies to accounting and therefore to audit reporting is as follows:

> A misstatement in the financial statements can be considered material if knowledge of the misstatement will affect a decision of a reasonable user of the statements.

In applying this definition, three levels of materiality are used for determining the type of opinion to issue.

Amounts Are Immaterial When a misstatement in the financial statements exists but is unlikely to affect the decisions of a reasonable user, it is considered to be immaterial. An unqualified opinion is therefore appropriate. For example, assume that management recorded prepaid insurance as an asset in the previous year and decides to expense it in the current year to reduce record-keeping costs. Management has failed to follow GAAP, but if the amounts are small, the misstatement is immaterial and a standard unqualified audit report is appropriate.

Amounts Are Material but Do Not Overshadow the Financial Statements as a Whole The second level of materiality exists when a misstatement in the financial statements would affect a user's decision, but the overall statements are still fairly stated and therefore useful. For example, knowledge of a large misstatement in fixed assets might affect a user's willingness to loan money to a company if the assets were the collateral. A misstatement of inventory does not mean that cash, accounts receivable, and other elements of the financial statements, or the financial statements as a whole, are materially incorrect.

To make materiality decisions when a condition requiring a departure from an unqualified report exists, the auditor must evaluate all effects on the financial statements. Assume that the auditor is unable to satisfy himself or herself whether inventory is fairly stated in deciding on the appropriate type of opinion. Because of the effect of a misstatement in inventory on other accounts and on totals in the statements, the auditor needs to consider the materiality of the combined effect on inventory, total current assets, total working capital, total assets, income taxes, income taxes payable, total current liabilities, cost of goods sold, net income before taxes, and net income after taxes.

When the auditor concludes that a misstatement is material but does not overshadow the financial statements as a whole, a qualified opinion (using "except for") is appropriate.

Amounts Are So Material or So Pervasive That Overall Fairness of the Statements Is in Question The highest level of materiality exists when users are likely to make incorrect decisions if they rely on the overall financial statements. To return to the previous example, if inventory is the largest balance on the financial statements, a large misstatement would probably be so material that the auditor's report should indicate the financial statements taken as a whole cannot be considered fairly stated. When the highest level of materiality exists, the auditor must issue either a disclaimer of opinion or an adverse opinion, depending on which conditions exist.

When determining whether an exception is highly material, the extent to which the exception affects different parts of the financial statements must be considered. This is called pervasiveness. A misclassification between cash and accounts receivable affects only those two accounts and is therefore not pervasive. On the other hand, failure to record a material sale is highly pervasive because it affects sales, accounts receivable, income tax expense, accrued income taxes, and retained earnings, which in turn affect current assets, total assets, current liabilities, total liabilities, owners' equity, gross margin, and operating income.

As misstatements become more pervasive, the likelihood of issuing an adverse opinion rather than a qualified opinion increases. For example, suppose the auditor decides a misclassification between cash and accounts receivable should result in a

TABLE 3-1	Relationship of Materiality to Type of Opinion	
Materiality Level	**Significance in Terms of Reasonable Users' Decisions**	**Type of Opinion**
Immaterial	Users' decisions are unlikely to be affected.	Unqualified
Material	Users' decisions are likely to be affected only if the information in question is important to the specific decisions being made. The overall financial statements are presented fairly.	Qualified
Highly material	Most or all users' decisions based on the financial statements are likely to be significantly affected.	Disclaimer or Adverse

Note: Lack of independence requires a disclaimer regardless of materiality.

qualified opinion because it is material; the failure to record a sale of the same dollar amount may result in an adverse opinion because of pervasiveness.

Regardless of the amount involved, a disclaimer of opinion must be issued if the auditor is determined to lack independence under the rules of the *Code of Professional Conduct.* This strict requirement reflects the importance of independence to auditors. Any deviation from the independence rule is therefore considered highly material. Table 3-1 summarizes the relationship between materiality and the type of opinion to be issued.

Materiality Decisions

In concept, the effect of materiality on the type of opinion to issue is straightforward. In application, deciding on actual materiality in a given situation is a difficult judgment. There are no simple, well-defined guidelines that enable auditors to decide when something is immaterial, material, or highly material. The evaluation of materiality also depends on whether the situation involves a failure to follow GAAP or a scope limitation.

Materiality Decisions—Non-GAAP Condition When a client has failed to follow GAAP, the audit report will be unqualified, qualified opinion only, or adverse, depending on the materiality of the departure. Several aspects of materiality must be considered.

Dollar Amounts Compared with a Benchmark The primary concern in measuring materiality when a client has failed to follow GAAP is usually the total dollar misstatement in the accounts involved, compared with some benchmark or base. A $10,000 misstatement might be material for a small company but not for a larger one. Therefore, misstatements must be compared with some measurement base before a decision can be made about the materiality of the failure to follow GAAP. Common bases include net income, total assets, current assets, and working capital.

For example, assume that the auditor believes there is a $100,000 overstatement of inventory because of the client's failure to follow GAAP. Also assume recorded inventory of $1 million, current assets of $3 million, and net income before taxes of $2 million. In this case, the auditor must evaluate the materiality of a misstatement of inventory of 10 percent, current assets of 3.3 percent, and net income before taxes of 5 percent.

To evaluate overall materiality, the auditor must also combine all unadjusted misstatements and judge whether there may be individually immaterial misstatements that, when combined, significantly affect the statements. In the inventory example just given, assume the auditor believes there is also an overstatement of $150,000 in accounts receivable. The total effect on current assets is now 8.3 percent ($250,000 divided by $3,000,000) and 12.5 percent on net income before taxes ($250,000 divided by $2,000,000).

When comparing potential misstatements with a base, the auditor must carefully consider all accounts affected by a misstatement (pervasiveness). For example, it is important not to overlook the effect of an understatement of inventory on cost of goods sold, income before taxes, income tax expense, and accrued income taxes payable.

Measurability The dollar amount of some misstatements cannot be accurately measured. For example, a client's unwillingness to disclose an existing lawsuit or the acquisition of a new company subsequent to the balance sheet date is difficult if not impossible to measure in terms of dollar amounts. The materiality question the auditor must evaluate in such situations is the effect on statement users of the failure to make the disclosure.

Nature of the Item The decision of a user may also be affected by the kind of misstatement. The following may affect a user's decision and therefore the auditor's opinion in a different way than most misstatements:

1. Transactions are illegal or fraudulent.
2. An item may materially affect some future period, even though it is immaterial when only the current period is considered.
3. An item has a "psychic" effect (for example, the item changes a small loss to a small profit, maintains a trend of increasing earnings, or allows earnings to exceed analysts' expectations).
4. An item may be important in terms of possible consequences arising from contractual obligations (for example, the effect of failure to comply with a debt restriction may result in a material loan being called).

Materiality Decisions—Scope Limitations Condition When there is a scope limitation in an audit, the audit report will be unqualified, qualified scope and opinion, or disclaimer, depending on the materiality of the scope limitation. The auditor will consider the same three factors included in the previous discussion about materiality decisions for failure to follow GAAP, but they will be considered differently. The size of *potential* misstatements, rather than known misstatements, is important in determining whether an unqualified report, a qualified report, or a disclaimer of opinion is appropriate for a scope limitation. For example, if recorded accounts payable of $400,000 was not audited, the auditor must evaluate the potential misstatement in accounts payable and decide how materially the financial statements could be affected. The pervasiveness of these potential misstatements must also be considered.

It is typically more difficult to evaluate the materiality of potential misstatements resulting from a scope limitation than for failure to follow GAAP. Misstatements resulting from failure to follow GAAP are known. Those resulting from scope limitations must usually be subjectively measured in terms of potential or likely misstatements. For example, a recorded accounts payable of $400,000 might be understated by more than $1 million, which may affect several totals, including gross margin, net earnings, and total assets.

DISCUSSION OF CONDITIONS REQUIRING A DEPARTURE

OBJECTIVE 3-7

Draft appropriately modified audit reports under a variety of circumstances.

You should now understand the relationships among the conditions requiring a departure from an unqualified report, the major types of reports other than unqualified, and the three levels of materiality. This part of the chapter examines the conditions requiring a departure from an unqualified report in greater detail and shows examples of reports under AICPA auditing standards. The wording of the opinion and the nature of the paragraph explaining the reason for a departure from the standard unqualified report is similar under PCAOB auditing standards.

Auditor's Scope Has Been Restricted

Two major categories of scope restrictions exist: those caused by a client and those caused by conditions beyond the control of either the client or the auditor. The effect on the auditor's report is the same for either, but the interpretation of materiality is likely to be different. When there is a scope restriction, the appropriate response is to issue an unqualified report, a qualification of scope and opinion, or a disclaimer of opinion, depending on materiality.

For client-imposed restrictions, the auditor should be concerned about the possibility that management is trying to prevent discovery of misstated information. In such cases, auditing standards encourage a disclaimer of opinion when materiality is in question. When restrictions result from conditions beyond the client's control, a qualification of scope and opinion is more likely.

Two restrictions occasionally imposed by clients on the auditor's scope relate to the observation of physical inventory and the confirmation of accounts receivable, but other restrictions may also occur. Reasons for client-imposed scope restrictions may be a desire to save audit fees and, in the case of confirming receivables, to prevent possible conflicts between the client and customer when amounts differ.

The most common case in which conditions beyond the client's and auditor's control cause a scope restriction is when the auditor is appointed after the client's balance sheet date. The confirmation of accounts receivable, physical examination of inventory, and other important procedures may be impossible under those circumstances. When the auditor cannot perform procedures he or she considers desirable but can be satisfied with alternative procedures that the information being verified is fairly stated, an unqualified report is appropriate. If alternative procedures cannot be performed, a qualified scope and opinion or disclaimer of opinion is necessary, depending on materiality.

A restriction on the scope of the auditor's examination requires a qualifying paragraph preceding the opinion to describe the restriction. For example, the report in Figure 3-8 is appropriate for an audit of a non-public entity in which the amounts were material but not pervasive and the auditor could not obtain audited financial statements supporting an investment in a foreign affiliate and could not satisfy himself or herself by alternate procedures.

When the amounts are so material that a disclaimer of opinion rather than a qualified opinion is required, the first (introductory) paragraph is modified slightly to say "We were engaged to audit . . . ." The first paragraph of the auditor's responsibility is modified to indicate that the auditor was not able to obtain sufficient appropriate

FIGURE 3-8 **Qualified Report Due to Scope Restriction – AICPA Auditing Standards**

INDEPENDENT AUDITOR'S REPORT

(Same introductory paragraph, management's responsibility paragraph, and first two auditor's responsibility paragraphs as the standard report)

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

Laughlin Corporation's investment in XYZ Company, a foreign affiliate acquired during the year and accounted for under the equity method, is carried at $2,475,000 on the balance sheet at December 31, 2013, and Laughlin's share of XYZ Company's net income of $365,000 is included in Laughlin Corporation's net income for the year then ended. We were unable to obtain sufficient appropriate evidence about the carrying amount of Laughlin Corporation's investment in XYZ Company as of December 31, 2013, and Laughlin's share of XYZ Company's net income for the year then ended because we were denied access to the financial information, management, and the auditors of XYZ Company. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of Laughlin Corporation as of December 31, 2013, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

FIGURE 3-9 **Disclaimer of Opinion Due to Scope Restriction – AICPA Auditing Standards**

INDEPENDENT AUDITOR'S REPORT

We were engaged to audit . . . *(remainder is the same as the introductory paragraph in the standard report)*

(Same management's responsibility paragraph as the standard report)

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with auditing standards generally accepted in the United States of America. Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

(Same wording as the Basis for Qualified Opinion paragraph in Figure 3-8)

Disclaimer of Opinion

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on these financial statements.

evidence to express an audit opinion. The last two paragraphs under auditor's responsibility included in the standard unqualified audit report are eliminated to avoid stating anything that might lead readers to believe that other parts of the financial statements were audited and therefore might be fairly stated. Figure 3-9 shows the audit report assuming the auditor had concluded that the facts in Figure 3-8 required a disclaimer rather than a qualified opinion.

Statements Are Not in Conformity with GAAP

When the auditor knows that the financial statements may be misleading because they were not prepared in conformity with GAAP, and the client is unable or unwilling to correct the misstatement, he or she must issue a qualified or an adverse opinion, depending on the materiality of the item in question. The opinion must clearly state the nature of the departure from accepted principles and the amount of

FIGURE 3-10 **Qualified Opinion Report Due to Non-GAAP – AICPA Auditing Standards**

INDEPENDENT AUDITOR'S REPORT

(Same introductory, management's responsibility, and auditor's responsibility paragraphs as the standard report)

Basis for Qualified Opinion

The Company has excluded from property and debt in the accompanying balance sheet certain lease obligations that, in our opinion, should be capitalized to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $4,600,000, long-term debt by $4,200,000, and retained earnings by $400,000 as of December 31, 2013, and net income and earnings per share would be increased by $400,000 and $1.75, respectively, for the year then ended.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of Ajax Company as of December 31, 2013, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

FIGURE 3-11 **Adverse Opinion Due to non-GAAP – AICPA Auditing Standards**

INDEPENDENT AUDITOR'S REPORT

(Same introductory, management's responsibility, and auditor's responsibility paragraphs as the standard report)

Basis for Adverse Opinion

(Same wording as the Basis for Qualified Opinion paragraph in Figure 3-10)

Adverse Opinion

In our opinion, because of the significance of the matter described in the Basis for Adverse Opinion paragraph, the financial statements referred to above do not present fairly the financial position of Ajax Company as of December 31, 2013, or the results of its operations and its cash flows for the year then ended.

the misstatement, if it is known. Figure 3-10 shows an example of a qualified opinion when a client did not capitalize leases as required by GAAP.

When the amounts are so material or pervasive that an adverse opinion is required, the scope is still unqualified and the qualifying paragraph can remain the same, but the opinion paragraph might be as shown in Figure 3-11.

When the client fails to include information that is necessary for the fair presentation of financial statements in the body of the statements or in the related footnotes, it is the auditor's responsibility to present the information in the audit report and to issue a qualified or an adverse opinion. It is common to put this type of qualification in an added paragraph preceding the opinion and to refer to the added paragraph in the opinion paragraph.

Rule 203 Reports Determining whether statements are in accordance with GAAP can be difficult. Rule 203 in the *Code of Professional Conduct* permits a departure from generally accepted accounting principles when the auditor believes that adherence to these would result in misleading financial statements, although this circumstance is rare.

When the auditor decides that adherence to GAAP would result in misleading statements, there should be a complete explanation in an added paragraph. The paragraph should fully explain the departure and why GAAP would result in misleading statements. The opinion paragraph should then be unqualified except for the reference to the added explanatory paragraph. As discussed earlier in the chapter, this is called an unqualified audit report with an emphasis-of-matter explanatory paragraph.

Auditor is Not Independent

If the auditor is not independent as specified by the *Code of Professional Conduct*, a disclaimer of opinion is required even though all the audit procedures considered necessary in the circumstances were performed. The wording in Figure 3-12 is recommended when the auditor is not independent.

The lack of independence overrides any other scope limitations. Therefore, no other reason for disclaiming an opinion should be cited. There should be no mention in the report of the performance of any audit procedures. As a result, it is a one-paragraph audit report.

FIGURE 3-12 **Disclaimer Due to Lack of Independence**

We are not independent with respect to Home Decors.com, Inc., and the accompanying balance sheet as of December 31, 2013, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us. Accordingly, we do not express an opinion on them.

Note: When the auditor lacks independence, no report title is included.

TABLE 3-2 **Audit Report for Each Condition Requiring a Departure from a Standard Unqualified Report at Different Levels of Materiality**

Condition Requiring an Unqualified Report with Modified Wording or Explanatory Paragraph	Level of Materiality: Immaterial	Level of Materiality: Material
Accounting principles not consistently applied*	Unqualified	Unqualified report, explanatory paragraph
Substantial doubt about going concern†	Unqualified	Unqualified report, explanatory paragraph
Justified departure from GAAP or other accounting principle	Unqualified	Unqualified report, explanatory paragraph
Emphasis of other matters	Unqualified	Unqualified report, explanatory paragraph
Use of another auditor	Unqualified	Unqualified report, modified wording

Condition Requiring a Departure from Unqualified Report	Level of Materiality: Immaterial	Material, But Does Not Overshadow Financial Statements as a Whole	So Material That Overall Fairness Is in Question
Scope restricted by client or other conditions	Unqualified	Additional paragraph, and qualified opinion (except for)	Disclaimer
Financial statements not prepared in accordance with GAAP‡	Unqualified	Additional paragraph and qualified opinion (except for)	Adverse
Justified departure from GAAP or other accounting principle	Unqualified	Disclaimer, regardless of materiality	

*If the auditor does not concur with the appropriateness of the change, the condition is considered a violation of GAAP.
†The auditor has the option of issuing a disclaimer of opinion.
‡If the auditor can demonstrate that GAAP would be misleading, an unqualified report with an explanatory paragraph is appropriate.

AUDITOR'S DECISION PROCESS FOR AUDIT REPORTS

OBJECTIVE 3-8

Determine the appropriate audit report for a given audit situation.

Auditors use a well-defined process for deciding the appropriate audit report in a given set of circumstances. The auditor must first assess whether any conditions exist requiring a departure from a standard unqualified report. If any conditions exist, the auditor must then assess the materiality of the condition and determine the appropriate type of report.

Determine Whether Any Condition Exists Requiring a Departure from a Standard Unqualified Report The most important of these conditions are identified in Table 3-2. Auditors identify these conditions as they perform the audit and include information about any condition in the audit files as discussion items for audit reporting. If none of these conditions exist, which is the case in most audits, the auditor issues a standard unqualified audit report.

Decide the Materiality for Each Condition When a condition requiring a departure from a standard unqualified opinion exists, the auditor evaluates the potential effect on the financial statements. For departures from GAAP or scope restrictions, the auditor must decide among immaterial, material, and highly material. All other conditions, except for lack of auditor independence, require only a distinction between immaterial and material. The materiality decision is a difficult one, requiring considerable judgment. For example, assume that there is a scope limitation in auditing inventory. It is difficult to assess the potential misstatement of an account that the auditor does not audit.

Decide the Appropriate Type of Report for the Condition, Given the Materiality Level After making the first two decisions, it is easy to decide the

> **RESEARCH UNDERWAY ON AUDIT REPORT**
>
> The AICPA Auditing Standards Board (ASB) and the International Auditing and Assurance Standards Board (IAASB) have partnered to commission academic research studying the effectiveness of communications provided by auditors in the audit report. Anecdotal evidence suggests that financial statement users may not consistently understand the information contained in the auditor's report, including the nature of the financial statement audit process and the level of assurance provided. For example, users of the audit report sometimes believe that an auditor's unqualified opinion provides an indication that a company's business model is sound or a user may conclude that the opinion provides absolute assurance that the financial statements are accurate. This research is being conducted with audit report users in the United States and internationally. Research findings will be used by the ASB and IAASB as they evaluate the effectiveness of audit reporting guidance in auditing standards.
>
> Source: Based on AICPA and IFAC, "Auditing Standards Board and International Auditing and Assurance Standards Board Request for Proposals for Research on Unqualified Auditor's Report Communications" (www.ifac.org).

appropriate type of opinion by using a decision aid. An example of such an aid is Table 3-2. For example, assume that the auditor concludes that there is a departure from GAAP and it is material, but not highly material. Table 3-2 shows that the appropriate audit report is a qualified opinion with an additional paragraph discussing the departure. The other report paragraphs will be included using standard wording.

Write the Audit Report Most CPA firms have computer templates that include precise wording for different circumstances to help the auditor write the audit report. Also, one or more partners in most CPA firms have special expertise in writing audit reports. These partners typically write or review all audit reports before they are issued.

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 or modification of the standard unqualified report. In these circumstances, the auditor should modify his or her opinion for each condition unless one has the effect of neutralizing the others. For example, if there is a scope limitation and a situation in which the auditor is not independent, the scope limitation should not be revealed. The following situations are examples when more than one modification should be included in the report:

- The auditor is not independent and the auditor knows that the company has not followed generally accepted accounting principles.
- There is a scope limitation and there is substantial doubt about the company's ability to continue as a going concern.
- There is a substantial doubt about the company's ability to continue as a going concern and information about the causes of the uncertainties is not adequately disclosed in a footnote.
- There is a deviation in the statements' preparation in accordance with GAAP and another accounting principle was applied on a basis that was not consistent with that of the preceding year.

INTERNATIONAL ACCOUNTING AND AUDITING STANDARDS

OBJECTIVE 3-9

Understand use of international accounting and auditing standards by U.S. companies.

The increasing globalization of the world's capital markets and the expanding presence of business operations in multiple countries are leading to calls for the establishment of a single set of accounting standards to be used around the world. IFRS is increasingly accepted worldwide as the basis of accounting used to prepare financial statements in other countries.

Currently, U.S. public companies are required to prepare financial statements that are filed with the Securities and Exchange Commission (SEC) in accordance with generally accepted accounting principles in the United States. The SEC is developing a work plan to determine whether to incorporate IFRS into the U.S. financial reporting system. Approval of the work plan could lead to the use of IFRS by U.S. public companies as early as 2015.

An auditor may be engaged to report on financial statements prepared in accordance with IFRS. When the auditor reports on financial statements prepared in conformity with IFRS, the auditor refers to those standards rather than U.S. generally accepted accounting principles as follows:

> In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Carlos Incorporated as of December 31, 2013 and 2012, and the results of its operations, comprehensive income, changes in equity, and its cash flows for the years then ended in conformity with International Financial Reporting Standards as issued by the International Accounting Standards Board.

As discussed in Chapter 2, the International Auditing and Assurance Standards Board (IAASB) issues International Standards on Auditing (ISAs). Auditing standards in the United States now allow an auditor to perform an audit of financial statements of a U.S. entity in accordance with both generally accepted auditing standards in the U.S. and the ISAs. The auditor's scope paragraph is modified to indicate that the audit was conducted in accordance with auditing standards generally accepted in the United States of America and in accordance with International Standards on Auditing.

SUMMARY

This chapter described the auditor's standard unqualified audit report under AICPA and PCAOB standards, as well as reports on internal control over financial reporting under Section 404 of the Sarbanes–Oxley Act. The four categories of audit reports and the auditor's decision process in choosing the appropriate audit report to issue were then discussed. In some circumstances, an explanatory paragraph or modification of the unqualified report is required. When there is a material departure from GAAP or a material limitation on the scope of the audit, an unqualified report cannot be issued. The appropriate report to issue in these circumstances depends on whether the situation involves a GAAP departure or a scope limitation, as well as the level of materiality.

ESSENTIAL TERMS

Adverse opinion—a report issued when the auditor believes the financial statements are so materially misstated or misleading as a whole that they do not present fairly the entity's financial position or the results of its operations and cash flows in conformity with GAAP

Combined report on financial statements and internal control over financial reporting—audit report on the financial statements and the effectiveness of internal control over financial reporting required for larger public companies under Section 404 of the Sarbanes–Oxley Act

Disclaimer of opinion—a report issued when the auditor is not able to become satisfied that the overall financial statements are fairly presented or the auditor is not independent

Material misstatement—a misstatement in the financial statements, knowledge of which would affect a decision of a reasonable user of the statements

Qualified opinion—a report issued when the auditor believes that the overall financial statements are fairly stated but that either the scope of the audit was limited or the financial data indicated a failure to follow GAAP

Separate report on internal control over financial reporting—audit report on the effectiveness of internal control over financial reporting required for larger public companies under Section 404 of the Sarbanes–Oxley Act that cross-references the separate audit report on the financial statements

Standard unqualified audit report—the report a CPA issues when all auditing conditions have been met, no significant misstatements have been discovered and left uncorrected, and it is the auditor's opinion that the financial statements are fairly stated in accordance with the applicable financial reporting framework

Unqualified audit report with explanatory paragraph or modified wording—an unqualified report in which the financial statements are fairly presented, but the auditor believes it is important, or is required, to provide additional information

REVIEW QUESTIONS

3-1 (Objective 3-1) Explain why auditors' reports are important to users of financial statements and why it is desirable to have standard wording.

3-2 (Objective 3-1) "The standard unqualified audit report is sometimes called a clean opinion because there are no circumstances requiring a qualification or modification of the auditor's opinion. The standard unqualified report is the most common audit opinion. Sometimes circumstances beyond the client's or auditor's control prevent the issuance of a clean opinion." Given this fact, explain the circumstances under which a standard unqualified audit report is issued.

3-3 (Objective 3-1) What are the purposes of the scope paragraph under the auditor's responsibility in the auditor's report? Identify the most important information included in the scope paragraph.

3-4 (Objective 3-1) What are the purposes of the opinion paragraph in the auditor's report? Identify the most important information included in the opinion paragraph.

3-5 (Objective 3-1) On February 17, 2014, a CPA completed all the evidence gathering procedures on the audit of the financial statements for the Buckheizer Technology Corporation for the year ended December 31, 2013. The audit is satisfactory in all respects except for the existence of a change in accounting principles from FIFO to LIFO inventory valuation, which results in an explanatory paragraph on consistency. On February 26, the auditor completed the tax return and the draft of the audit report. The final audit report was completed, attached to the financial statements, and delivered to the client on March 7. What is the appropriate date on the auditor's report?

3-6 (Objective 3-2) What four circumstances are required for a standard unqualified report to be issued?

3-7 (Objective 3-3) Describe the information included in the introductory, scope, and opinion paragraphs in a separate audit report on the effectiveness of internal control over financial reporting. What is the nature of the additional paragraphs in the audit report?

3-8 (Objectives 3-1, 3-3) Compare the wording in the standard unqualified report for a non-public entity under AICPA auditing standards in Figure 3-1 with the wording for a public company audit under PCAOB auditing standards in Figure 3-3. How are the reports similar? How are they different?

3-9 (Objectives 3-4, 3-5) Distinguish between an unqualified report with an emphasis-of-matter explanatory paragraph or modified wording, and a qualified report. Give examples of when an explanatory paragraph or modified wording should be used in an unqualified opinion.

3-10 (Objective 3-4) Describe what is meant by reports involving the use of other auditors. What are the three options available to the primary auditor responsible for the opinion, and when should each be used?

3-11 (Objective 3-4) The client has restated the prior-year statements because of a change from LIFO to FIFO. How should this be reflected in the auditor's report?

3-12 (Objective 3-4) Distinguish between changes that affect consistency and those that may affect comparability but not consistency. Give an example of each.

3-13 (Objective 3-5) List the three conditions that require a departure from an unqualified opinion and give one specific example of each of those conditions.

3-14 (Objective 3-5) Distinguish between a qualified opinion, an adverse opinion, and a disclaimer of opinion, and explain the circumstances under which each is appropriate.

3-15 (Objective 3-6) Define materiality as it is used in audit reporting. What conditions will affect the auditor's determination of materiality?

3-16 (Objective 3-6) Explain how materiality definitions and materiality decisions are taken in non-GAAP conditions?

3-17 (Objective 3-7) How does the auditor's opinion differ between scope limitations caused by client restrictions and limitations resulting from conditions beyond the client's control? Under which of these two will the auditor be most likely to issue a disclaimer of opinion? Explain.

3-18 (Objective 3-5) Distinguish between a report qualified as to opinion only and one qualified due to a scope limitation.

3-19 (Objectives 3-6, 3-7) Identify the three alternative opinions that may be appropriate when the client's financial statements are not in accordance with GAAP. Under what circumstance is each appropriate?

3-20 (Objective 3-8) When an auditor discovers more than one condition that requires departure from or modification of the standard unqualified report, what should the auditor's report include?

3-21 (Objective 3-9) The ISAs allow an auditor to include either of the following phrases in the auditor's opinion paragraph: (1) "The financial statements present fairly, in all material respects..." or (2) "The financial statements give a true and fair view of...". Discuss whether the ASB should adopt a similar option for U.S. audit standards.

3-22 (Objective 3-9) Discuss why the adoption of international accounting and auditing standards might be beneficial to investors and auditors.

MULTIPLE CHOICE QUESTIONS FROM CPA EXAMINATIONS

3-23 (Objectives 3-1, 3-2, 3-3, 3-4, 3-8) The following questions concern unqualified audit reports. Choose the best response.

a. Which of the following is not a required element of a standard unqualified audit report issued in accordance with AICPA auditing standards?
   (1) A title that emphasizes the report is from an independent auditor.
   (2) The signature of the engagement partner.
   (3) The city and state of the audit firm issuing the report.
   (4) A statement explaining management's responsibilities for the financial statements.

b. The date of the CPA's opinion on the financial statements of the client should be the date of the
   (1) closing of the client's books.
   (2) finalization of the terms of the audit engagement.
   (3) completion of all important audit procedures.
   (4) submission of the report to the client.

c. If a principal auditor decides to refer in his or her report to the audit of another auditor, he or she is required to disclose the
   (1) name of the other auditor.
   (2) nature of the inquiry into the other auditor's professional standing and extent of the review of the other auditor's work.
   (3) portion of the financial statements audited by the other auditor.
   (4) reasons for being unwilling to assume responsibility for the other auditor's work.

3-24 (Objectives 3-4, 3-8) The following questions concern unqualified audit reports with an emphasis-of-matter explanatory paragraph or modified wording. Choose the best response.

a. An entity changed from the straight-line method to the declining-balance method of depreciation for all newly acquired assets. This change has no material effect on the current year's financial statements but is reasonably certain to have a substantial effect in later years. If the change is disclosed in the notes to the financial statements, the auditor should issue a report with a(n)
   (1) qualified opinion.
   (2) unqualified opinion with explanatory paragraph.
   (3) unqualified opinion.
   (4) qualified opinion with explanatory paragraph regarding consistency.

b. When the financial statements are fairly stated but the auditor concludes there is substantial doubt whether the client can continue in existence, the auditor should issue a(n)
   (1) adverse opinion.
   (2) qualified opinion only.
   (3) unqualified opinion.
   (4) unqualified opinion with explanatory paragraph.

c. The auditor's report contains the following: "We did not audit the financial statements of EZ, Inc., a wholly owned subsidiary, which statements reflect total assets and revenues constituting 27 percent and 29 percent, respectively, of the consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for EZ, Inc., is based solely on the report of the other auditors." These sentences
   (1) indicate a division of responsibility.
   (2) assume responsibility for the other auditor.
   (3) require a departure from an unqualified opinion.
   (4) are an improper form of reporting.

3-25 (Objectives 3-5, 3-7, 3-8) The following questions concern audit reports other than unqualified audit reports with standard wording. Choose the best response.

a. The annual audit of Midwestern Manufacturing revealed that sales were accidentally being recorded as revenue when the goods were ordered, instead of when they were shipped. Assuming the amount in question is material and the client is unwilling to correct the error, the CPA should issue:
   (1) an unqualified opinion or adverse opinion.
   (2) a qualified "except for" opinion or disclaimer of opinion.
   (3) a qualified "except for" opinion or adverse opinion.
   (4) an unqualified opinion with an explanatory paragraph

b. Under which of the following circumstances would a disclaimer of opinion not be appropriate?
   (1) The auditor is unable to determine the amounts associated with an employee fraud scheme.
   (2) Management does not provide reasonable justification for a change in accounting principles.
   (3) The client refuses the auditor permission to confirm certain accounts receivable or apply alternative procedures to verify their balances.
   (4) The chief executive officer is unwilling to sign the management representation letter.

c. The opinion paragraph of a CPA's report states: "In our opinion, except for the effects of not capitalizing certain lease obligations, as discussed in the preceding paragraph, the financial statements present fairly, in all material respects...." This paragraph expresses a(n)
   (1) unqualified opinion.
   (2) unqualified opinion with explanatory paragraph.
   (3) qualified opinion.
   (4) adverse opinion.

DISCUSSION QUESTIONS AND PROBLEMS

3-26 (Objective 3-1) A careful reading of an unqualified report indicates several important phrases. Explain why each of the following phrases or clauses is used rather than the alternative provided:

a. "The financial statements referred to above present fairly, in all material respects, the financial position" rather than "The financial statements mentioned above are correctly stated."

b. "In conformity with accounting principles generally accepted in the United States of America" rather than "are properly stated to represent the true economic conditions."

c. "In our opinion, the financial statements present fairly" rather than "The financial statements present fairly."

d. "Brown & Phillips, CPAs (firm name)," rather than "James E. Brown, CPA (individual partner's name)."

e. "We conducted our audit in accordance with auditing standards generally accepted in the United States of America" rather than "Our audit was performed to detect material misstatements in the financial statements."

3-27 (Objectives 3-1, 3-2, 3-4, 3-6, 3-7) Patel, CPA, has completed the audit of the financial statements of Bellamy Corporation as of and for the year ended December 31, 2013. Patel also audited and reported on the Bellamy financial statements for the prior year. Patel drafted the following report for 2013.

> We have audited the balance sheet and statements of income and retained earnings of Bellamy Corporation as of December 31, 2013. We conducted our audit in accordance with generally accepted accounting standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of misstatement.
>
> We believe that our audits provide a reasonable basis for our opinion.
>
> In our opinion, the financial statements referred to above present fairly the financial position of Bellamy Corporation as of December 31, 2013, and the results of its operations for the year then ended in conformity with generally accepted auditing standards, applied on a basis consistent with those of the preceding year.
>
> Patel, CPA
> (Signed)

Other Information

- Bellamy is a private corporation and is presenting comparative financial statements.
- Bellamy does not wish to present a statement of cash flows for either year.
- During 2013, Bellamy changed its method of accounting for long-term construction contracts and properly reflected the effect of the change in the current year's financial statements and restated the prior year's statements. Patel is satisfied with Bellamy's justification for making the change. The change is discussed in footnote 12.
- Patel was unable to perform normal accounts receivable confirmation procedures, but alternative procedures were used to satisfy Patel as to the existence of the receivables.
- Bellamy Corporation is the defendant in a litigation, the outcome of which is highly uncertain. If the case is settled in favor of the plaintiff, Bellamy will be required to pay a substantial amount of cash, which might require the sale of certain fixed assets. The litigation and the possible effects have been properly disclosed in footnote 11.
- Bellamy issued debentures on January 31, 2012, in the amount of $10 million. The funds obtained from the issuance were used to finance the expansion of plant facilities. The debenture agreement restricts the payment of future cash dividends to earnings after December 31, 2017. Bellamy declined to disclose this essential data in the footnotes to the financial statements.

Required

a. Identify and explain any items included in "Other Information" that need not be part of the auditor's report.

b. Explain the deficiencies in Patel's report as drafted.*

3-28 (Objectives 3-4, 3-5, 3-6, 3-7, 3-8) For the following independent situations, assume that you are the audit partner on the engagement:

1. During your audit of Raceway.com, Inc., you conclude that there is a possibility that inventory is materially overstated. The client refuses to allow you to expand the scope of your audit sufficiently to verify whether the balance is actually misstated.
2. You complete the audit of Munich Department Store, and in your opinion, the financial statements are fairly presented. On the last day of the audit, you discover that one of your supervisors assigned to the audit has a material investment in Munich.
3. Auto Delivery Company has a fleet of several delivery trucks. In the past, Auto Delivery had followed the policy of purchasing all equipment. In the current year, they decided to lease the trucks. The method of accounting for the trucks is therefore changed to lease capitalization. This change in policy is fully disclosed in footnotes.
4. You are auditing Deep Clean Services for the first time. Deep Clean has been in business for several years but over the last two years has struggled to stay afloat given the economic conditions. Based on your audit work, you have substantial doubt that Deep Clean will be in business by the end of its next fiscal year.
5. One of your audit clients has a material investment in a privately-held biosciences company. Your audit firm engaged a business valuation specialist to assist in evaluating the client's estimation of the investment's fair value. You conclude that the valuation specialist's work provides sufficient appropriate audit evidence.
6. Four weeks after the year-end date, a major customer of Prince Construction Co. declared bankruptcy. Because the customer had confirmed the balance due to Prince at the balance sheet date, management refuses to charge off the account or otherwise disclose the information. The receivable represents approximately 10% of accounts receivable and 20% of net earnings before taxes.

Required

For each situation, do the following:

a. Identify which of the conditions requiring a modification of or a deviation from an unqualified standard report is applicable.

b. State the level of materiality as immaterial, material, or highly material. If you cannot decide the level of materiality, state the additional information needed to make a decision.

c. Given your answers in parts a. and b., state the type of audit report that should be issued. If you have not decided on one level of materiality in part b., state the appropriate report for each alternative materiality level.

3-29 (Objectives 3-4, 3-5, 3-6, 3-7, 3-8) For the following independent situations, assume that you are the audit partner on the engagement:

1. Intelligis Electronics is a manufacturer of advanced electrical components. During the year, changes in the market resulted in a significant decrease in the demand for their products, which are now being sold significantly below cost. Management refuses to write-off the products or to increase the reserve for obsolescence.
2. In the last 3 months of the current year, Oil Refining Company decided to change direction and go significantly into the oil drilling business. Management recognizes that this business is exceptionally risky and could jeopardize the success of its existing refining business, but there are significant potential rewards. During the short period of operation in drilling, the company has had three dry wells and no successes. The facts are adequately disclosed in footnotes.
3. Your client, Harrison Automotive, has changed from straight-line to sum-of-the-years' digits depreciation. The effect on this year's income is material, and the effect in future years is likely to be highly material. The facts are adequately disclosed in footnotes.

4. Toronto Technology Corporation has prepared financial statements but has decided to exclude the statement of cash flows. Management explains to you that the users of their financial statements find this statement confusing and prefer not to have it included.
5. Marseilles Fragrance, Inc., is based in New York but has operations throughout Europe. Because users of the audited financial statement are international, your audit firm was engaged to conduct the audit in accordance with U.S. auditing standards and International Standards on Auditing (ISAs).
6. The controller of Brentwood Industries, Inc., will not allow you to confirm the receivable balance from two of its major customers. The amounts of the receivables are material in relation to Brentwood Industries' financial statements. You are unable to satisfy yourself as to the receivable balances by alternative procedures.
7. Approximately 20% of the audit of Lumberton Farms, Inc., was performed by a different CPA firm, selected by you. You have reviewed their audit files and believe they did an excellent job on their portion of the audit. Nevertheless, you are unwilling to take complete responsibility for their work.

Required For each situation, do the following:

a. Identify which of the conditions requiring a modification of or a deviation from an unqualified standard report is applicable.

b. State the level of materiality as immaterial, material, or highly material. If you cannot decide the level of materiality, state the additional information needed to make a decision.

c. Given your answers in parts a. and b., state the appropriate audit report from the following alternatives (if you have not decided on one level of materiality in part b., state the appropriate report for each alternative materiality level):

(1) Unqualified—standard wording
(2) Unqualified—explanatory paragraph
(3) Unqualified—modified wording
(4) Qualified opinion only—GAAP departure
(5) Qualified opinion—scope limitation
(6) Disclaimer
(7) Adverse*

3-30 (Objectives 3-4, 3-5, 3-6, 3-7, 3-8) For the following independent situations, assume that you are the audit partner on the engagement:

1. McClellan's Used Cars, a client of yours, recently changed its depreciation method from straight-line to sum-of-the-years' digits. The effect of the change on the current year's income is not material, but in future years, you suspect the effect will become material. The facts are adequately disclosed in footnotes.
2. Jordan Minerals recently decided to change its direction and spent the last 8 months developing business in the potash mining business. There are significant potential rewards, but the company's management recognizes that there are significant risks in the business that could jeopardize the success of its existing mining business. Since starting the new venture, the company has had no successes and some decline in profits. The facts are adequately disclosed in footnotes.
3. You recently noticed that Janssen Technology Solutions routinely excludes their statement of cash flows in the company's annual financial statements. Their reasoning, as explained to you, is that the statements are confusing to their readers, so they prefer to leave the information out.

4. A group of longtime friends decided to try their hand at online art auctions and online trade in antiquities. Although their venture started out well enough, a market-wide downturn in e-commerce sales abruptly plunged the start-up into the red. The future of the company looks bleak; both sales and cash position have declined substantially. If the market does not turn around soon, you think the company may not be able to continue to operate.
5. The controller of a company you're auditing will not allow you to confirm the receivable balances from any of its customers. However, the amounts of the receivables are material in relation to the company's financial statements.You cannot use any other methods to check the receivable balances.
6. Your firm has been unusually busy, so you asked another CPA firm to do about 30% of the audit for Abdoun's Arts, Inc. After a thorough review of their working papers, you are convinced that they did an excellent job on their portion of the audit. However, you are reluctant to take complete responsibility for their work.

Required

For each situation, do the following:

a. Identify which of the conditions requiring a modification of or a deviation from an unqualified standard report is applicable.

b. State the level of materiality as immaterial, material, or highly material. If you cannot decide the level of materiality, state the additional information needed to make a decision.

c. Given your answers in parts a. and b., state the appropriate audit report from the following alternatives (if you have not decided on one level of materiality in part b., state the appropriate report for each alternative materiality level):

(1) Unqualified—standard wording
(2) Unqualified—explanatory paragraph
(3) Unqualified—modified wording
(4) Qualified opinion only
(5) Qualified scope and opinion
(6) Disclaimer
(7) Adverse*

d. Based on your answer to part c., indicate which paragraphs, if any, should be modified in the standard audit report. Also indicate whether an additional paragraph is necessary and its location in the report.

3-31 (Objective 3-4) Various types of "accounting changes" can affect audit reporting. AICPA auditing standards indicate that an emphasis-of-matter explanatory paragraph should be included when accounting principles have not been consistently applied in the current period in relation to the preceding period. Assume that the following list describes changes that have a material effect on a client's financial statements for the current year:

1. Correction of a mathematical error in inventory pricing made in a prior period.
2. A change from deferring and amortizing preproduction costs to recording such costs as an expense when incurred because future benefits of the costs have become doubtful. The new accounting method was adopted in recognition of the change in estimated future benefits.
3. A change from the completed-contract method to the percentage-of-completion method of accounting for long-term construction contracts.

4. A change in the estimated useful life of previously recorded fixed assets based on newly acquired information
5. A change to including the employer share of Social Security (FICA) taxes as "retirement benefits" on the income statement from including it with "other taxes."
6. A change from prime costing to full absorption costing for inventory valuation.
7. A change from presentation of statements of individual companies to presentation of consolidated statements.
8. A change from the FIFO method of inventory pricing to the LIFO method of inventory pricing.

Required Identify the type of change described in each item above, and state whether any modification is required in the auditor's report as it relates to consistency. Organize your answer sheet as shown. For example, a change from the LIFO method of inventory pricing to the FIFO method of inventory pricing would appear as shown.

Assume that each item is material.*

Item No.	Type of Change	Should Auditor's Report Be Modified?
Example	An accounting change from one generally accepted accounting principle to another generally accepted accounting principle	Yes

RESEARCH PROBLEM 3-1: RESEARCH ANNUAL REPORTS

The U.S. Securities and Exchange Commission (SEC) is an independent, nonpartisan, quasi-judicial regulatory agency with responsibility for administering the federal securities laws. Publicly traded companies must electronically file a variety of forms or reports with the SEC (for example, annual financial statements). The SEC makes most of these electronic documents available on the Internet via EDGAR. EDGAR stands for Electronic Data Gathering, Analysis, and Retrieval system. The primary purpose for EDGAR is to increase the efficiency and fairness of the securities market for the benefit of investors, corporations, and the economy by accelerating the receipt, acceptance, dissemination, and analysis of time-sensitive corporate information filed with the agency.

Required

a. Visit the SEC Web site (www.sec.gov) and review the information under the link to "Descriptions of Forms" to find the definitions for these forms: 8-K, 10-K, 10-Q, and DEF-14a.

b. Visit the link to "Search for Company Filings" and locate the Form 10-K filing for Google, Inc., for the year ended December 31, 2011, to answer the following questions:
   1. Who was Google's auditor?
   2. Did the audit firm issue a combined or separate report(s) on the financial statements and on internal controls over financial reporting?
   3. What type of audit opinion did the auditor provide for the financial statements?
   4. What was the auditor's opinion about internal controls over financial reporting?
   5. What was the report date for the audit report?

c. Search for the Form 10-K filing for Yahoo, Inc., for the year ended December 31, 2011, to answer the following questions:
   1. What type of audit opinion did Yahoo's auditor provide for the financial statements and for internal controls over financial reporting?
   2. What was the report date for the audit report?
   3. How does the Yahoo auditor's report on the financial statements differ from the audit report related to Google's financial statements?