



# AUDITORS' RESPONSIBILITIES AND REPORTS

## AUDITOR RESPONSIBILITY FOR GOING CONCERN

An auditor has a responsibility to determine if substantial doubt exists at the date of the auditor's report about whether the audit client can continue as a going concern for the next year. The auditor bases this evaluation on the evidence obtained in performing the audit and considers the entity's financial position as of the balance sheet date.

Now consider the following information. As the auditor is completing the audit, the auditor notes the following circumstances.

- In the last year revenues have grown 2 $\frac{1}{2}$  times, but profitability has fallen from 2 percent to 1 percent of sales. Nevertheless, the company reports over \$1 billion in net income.
- The entity's ratio of debt to equity has grown from 2.5:1 to 4.7:1.
- Fifty-two percent of pretax income is from noncash sources.
- Reported cash flow from operations increases from \$1.2 billion to \$4.7 billion; however, a significant portion of operating cash flows may not be recurring.
- The company had cash and cash equivalents of \$1.3 billion at year-end.
- In the normal course of business, the company must retire debt in the coming year in the amount of about \$2.1 billion.
- Prices for the company's products are at record highs, and the product is in high demand.
- The company's stock is near an all-time high, and the company has access to equity markets.
- The company has an investment grade credit rating, and it has over \$2 billion in committed lines of credit.

If this is what you know about the company as you are completing your audit, take a moment and consider whether the auditor should have *substantial doubt* about whether the entity can continue as a going concern. Does *substantial doubt* exist? Is evaluating whether substantial doubt exists a clear-cut right or wrong issue? Yes or no?

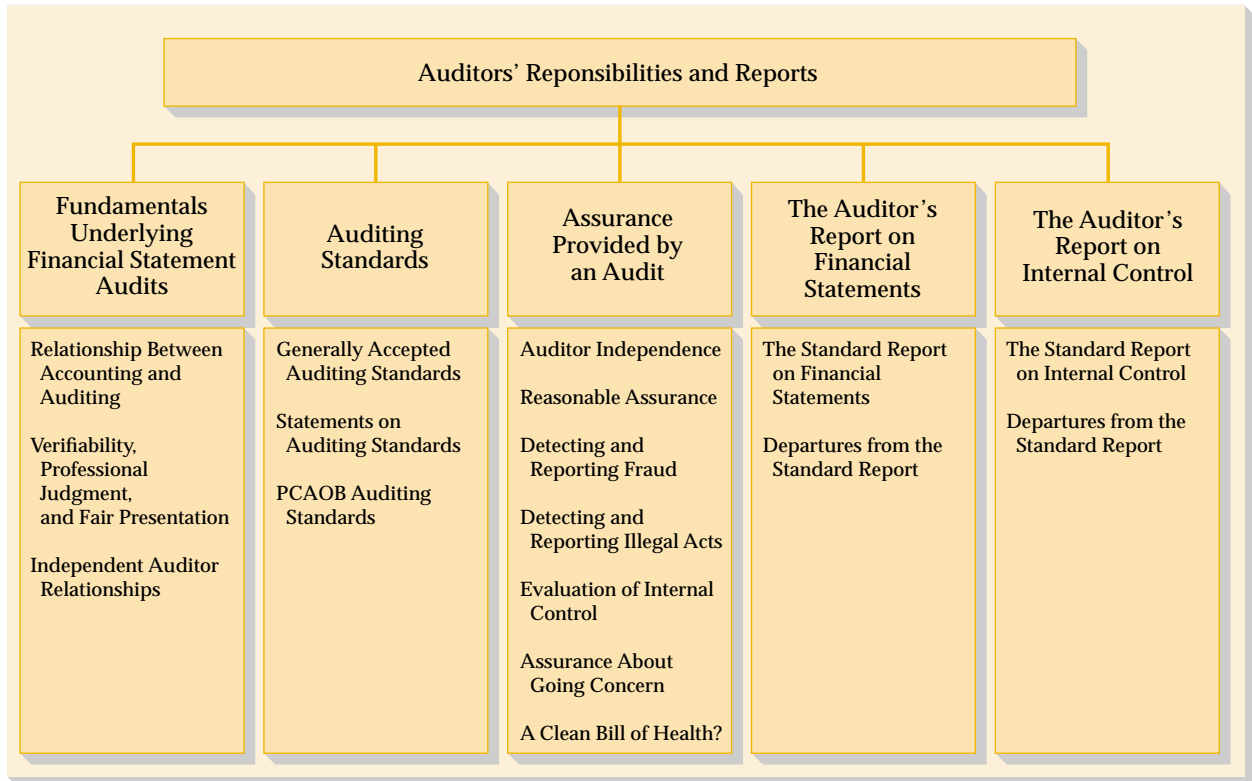
This information was taken from Enron's financial statements as of December 31, 2000. On December 2, 2001, Enron filed for bankruptcy protection. Should Andersen have issued a going-concern opinion when its audit opinion was issued on February 23, 2001? Or did Enron fail primarily because of events that happened during 2001 and were not known in February 2001? Although Andersen was heavily criticized for its failure to find material misstatements in Enron's report on financial position and results of operations (debt to equity should have been 5.3:1, and net income should have been \$847 million rather than \$979 million), there have been few criticisms of the fact that it did not issue a going-concern opinion.

Read on in this chapter to better understand the auditor's responsibility, not just with respect to going concern, but other responsibilities as well.

**Source:** Enron Financial Statements as of December 31, 2000.

## PREVIEW OF CHAPTER 2

If an audit firm performs a high-quality audit, what is the standard by which users should judge its responsibility to find material misstatements and fraud in financial statements? What is the auditor's responsibility to address such issues as whether an entity is a going concern or whether the entity has violated the law? What responsibility does an auditor have to evaluate an entity's system of internal control? Chapter 2 explains the auditor's basic responsibilities and discusses how the auditor communicates the primary findings of an audit in an auditor's report on the financial statements. The chapter also explains how the auditor communicates findings in an audit report on internal control over financial reporting in the audit of a public company. The following diagram provides an overview of the chapter organization and content.



Chapter 2 addresses the following aspects of the auditor's knowledge and focuses on two important audit decisions addressed below.

### focus on auditor knowledge

After studying this chapter you should understand the following aspects of an auditor's knowledge base:

- K1.** Know the relationship between accounting and auditing.
- K2.** Understand how the concept of verifiability relates to the concept of "fair presentation, in all material respects."
- K3.** Understand the auditor's relationship with management, the board of directors, the audit committee, and other groups.

- K4. Know the 10 generally accepted auditing standards.
- K5. Understand some important auditor's responsibilities that are implied by completing the audit.
- K6. Understand the basic elements of the auditor's standard report on financial statements.
- K7. Understand the basic elements of the auditor's standard report on internal controls over financial reporting.

### focus on audit decisions

After studying this chapter you should understand the factors that influence the following audit decisions.

- D1. When should the auditor use a nonstandard report on financial statements?
- D2. When should the auditor use a nonstandard report on internal controls over financial reporting?

## FUNDAMENTALS UNDERLYING FINANCIAL STATEMENT AUDITS

In this section, we examine the relationship between accounting and auditing. This section also explores the concept of verifiability in auditing and its relationship with the concept of reasonable assurance.

### RELATIONSHIP BETWEEN ACCOUNTING AND AUDITING

There are significant differences in the methods, objectives, and parties responsible for the accounting process by which the financial statements are prepared and for the audit of the statements. Recall from Chapter 1 that management is responsible for the financial statements and related disclosures and that the auditor is responsible for obtaining reasonable assurance that those financial statements are presented fairly in all material respects.

Accounting methods involve identifying the events and transactions that affect the entity. Once identified, these items are measured, recorded, classified, and summarized in the accounting records. In addition, management should institute a system of internal control over that process to improve the reliability of financial reporting. The result of this process is the preparation and distribution of financial statements that are in conformity with generally accepted accounting principles (GAAP). The ultimate objective of accounting is the communication of relevant and reliable financial data that will be useful for decision making. Thus, accounting is a creative process. An entity's employees are involved in the accounting process, and ultimate responsibility for the financial statements lies with the entity's management.

The typical audit of financial statements involves performing risk assessment procedures to understand the entity's business and industry, including its system of internal control. This knowledge allows the auditor to develop a point of view regarding the risk of material misstatement. Armed with this knowledge, the auditor designs audit procedures to obtain evidence that are responsive to the

#### Auditor Knowledge 1

- Know the relationship between accounting and auditing.

assessed risks. The auditor uses this knowledgeable perspective to see if the risks are, in fact, present. Ultimately, the goal of a high-quality audit is to obtain reasonable assurance that the financial statements present fairly the entity's financial position, results of operations, and cash flows in conformity with GAAP.<sup>1</sup> Rather than creating new information, the primary objective of auditing is to add credibility to the financial statements prepared by management. Audits allow financial statement users to make decisions with knowledge about a high level of integrity (but not a guarantee) of the information that they are using to support their decisions.

The relationship between accounting and auditing in the financial reporting process is illustrated in Figure 2-1.

The current financial reporting model focuses on the measurement and reporting of transactions in financial statements. This process includes significant professional judgment involved in evaluating the reasonableness of accounting estimates. For example, today's financial reporting model expects management to estimate future cash flows from past transactions. Specifically, management must estimate current receivables that may not be collected in the future or examine whether the entity will sell the current inventory in the future at a price that is sufficient to recover its cost. The most significant challenge in today's audits comes from the prospective elements embedded in the current financial reporting model.

The majority of this book focuses on the audit of financial statements. However, audits of public companies are integrated audits in which the auditor audits (1) the financial statements, (2) management's assertion about the effectiveness of its internal control over financial reporting, and (3) the underlying effectiveness of the system of internal control. Although our primary focus is on the financial statement audit, in particular sections we will highlight the auditor's responsibility and communications with respect to auditing internal controls over financial reporting.

The auditor's understanding of the total business provides the context for many audit tests and positions the auditor to discuss a variety of accounting and financial performance issues with the audit committee or the board of directors. Furthermore, management may engage the auditor to provide other assurance services that build on the knowledge obtained while performing the audit.

## VERIFIABILITY, PROFESSIONAL JUDGMENT, AND FAIR PRESENTATION

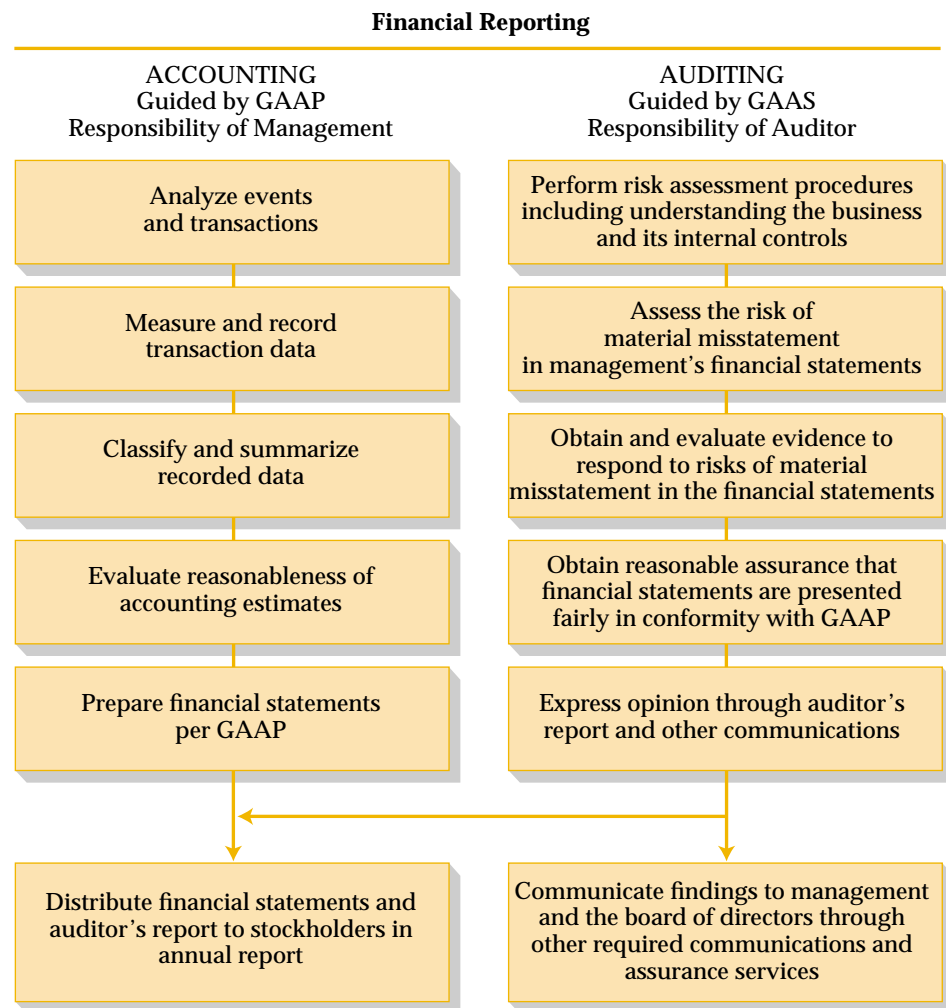
Auditing is based on the assumption that financial statement data are verifiable. Data are verifiable when two or more qualified individuals, working independently, reach essentially similar conclusions from an examination of the data. Verifiability is primarily concerned with the availability of evidence attesting to the validity of the information being considered. In some disciplines, data are considered verifiable only if the examiners can prove beyond all doubt that the data are either true or false. This is not the case in accounting and auditing.

### Auditor Knowledge 2

■ Understand how the concept of verifiability relates to the concept of "fair presentation, in all material respects."

<sup>1</sup> In the case of public companies, the auditor should follow the standards of the Public Companies Accounting Oversight Board. In April 2003 the PCAOB adopted generally accepted auditing standards, and they will suggest modifications as appropriate for the audits of public companies.

Figure 2-1 ■ Relationship Between Accounting and Auditing



The concept of “**fair presentation** of financial position, results of operations, and cash flows, in all material respects” implies that there is a level of imprecision in accounting. Consider the following examples.

- How precise is the balance for cash? In fact, it is fairly precise and is based on the amount of cash on deposit after accounting for deposits in transit, outstanding checks, and other reconciling items.
- How precise is the balance for accounts receivable? Gross receivables can be fairly precise if it is based on actual shipment made and sales prices. However, revenue recognition practices in some industries (e.g., software, long-term contracts) require significant estimation. Moreover, the allowance for doubtful accounts adds an element of estimation and imprecision to the process of preparing financial statements.
- How precise is the balance for inventory? How many different ways can a company compute the value of inventory? LIFO? dollar value LIFO? FIFO? the retail

method? There may be a material difference in the valuation of inventory based on the choice of inventory methods. Furthermore, should variances from standard costs be included in inventory or directly expensed as part of cost of sales? Such questions must be answered to determine the cost of inventory, let alone considering the estimation involved in evaluating the net realizable value of inventory.

The imprecision in accounting leads to an imprecision in the ability to verify financial statement presentations. Accounting and auditing require the application of significant professional judgment. Hence, the auditor seeks only a reasonable basis for expressing an opinion on the fairness of the financial statements. In making an examination, the auditor obtains evidence for sound and well-grounded conclusions about the *fairness* and *representational faithfulness* of the accounting treatment of transactions, balances, and disclosures in the financial statements.

In addition, auditors must consider cost-benefit tradeoffs when performing an audit. Hence, an audit is only designed to look for misstatements in financial statements that are **material**, or significant, to financial statement users. Auditors may not attempt to verify items that are so small, or immaterial, that they have no significance for financial statement users. If various accounts included in accounts receivable are so small that they could not aggregate to an amount that would influence a financial statement user, the auditor will spend little time and effort verifying those accounts. In turn, the auditor does not perform a 100 percent audit. The auditor does, however, focus attention on those items that could aggregate to an amount that would be material, or significant, to a financial statement user. The concept of “fair presentation, in all material respects” implies that the auditor’s involvement simply assures their reasonableness, not exactness.

## INDEPENDENT AUDITOR RELATIONSHIPS

In a financial statement audit, the auditor maintains professional relationships with four important groups: (1) management, (2) the board of directors and audit committee, (3) internal auditors, and (4) stockholders.

### Management

The term **management** refers collectively to individuals who actively plan, coordinate, and control the entity’s operations and transactions. In an auditing context, management refers to the company officers, including its chief executive officer, its chief financial and operating officers, and key supervisory personnel. It is management that is responsible for fairly presenting financial position, results of operations, and cash flows in financial statements, not the auditor.

During the course of an audit, extensive interaction takes place between the auditor and management. To obtain the evidence needed in an audit, the auditor often requires confidential data about the entity. An adversary relationship will not work. Neither will a relationship in which management attempts to conceal evidence. It is imperative, therefore, to have a relationship based on mutual trust, respect, and a high degree of candor. Even with a high degree of mutual trust and respect, the typical approach the auditor should take toward management’s assertions may be characterized as one of **professional skepticism**. This means that the auditor recognizes the need to objectively evaluate conditions observed and evidence obtained during the audit. The auditor should neither disbelieve management’s assertions nor glibly accept them without underlying evidence.

#### Auditor Knowledge 3

■ Understand the auditor’s relationship with management, the board of directors, the audit committee, and other groups.

### Board of Directors and Audit Committee

The board of directors of a corporation is responsible for seeing that the corporation is operated in the best interests of the stockholders. The auditor's relationship with the directors depends largely on the composition of the board. In the case of many private companies, the board consists primarily of company officers (who often are also majority shareholders), and the auditor's relationship with the board and management is essentially one and the same. Many private companies do not have audit committees, in which case the auditor communicates required communications, such as weaknesses in internal controls or concerns about financial reporting, to the board as a whole. Even though management may own a majority of the shares of private companies, auditors should maintain an adequate degree of professional skepticism and consider the interests of minority shareholders.

Public companies usually have a number of independent, outside members on the board. Outside members may be owners in a company, but they are not officers or employees of the company and they usually only receive compensation from the company for their service as a director. (Compensation may be in the form of direct cash payments or stock options.) Public company **audit committees**, composed exclusively of outside, independent members of the board, serve as an intermediary between the auditor and management. Today public company audit committees must have individuals with significant accounting knowledge. The functions of an audit committee, as outlined in Section 301 of the Sarbanes-Oxley Act of 2002, is directly responsible for:

- Appointment, compensation, and oversight of the public accounting firm to conduct the annual audit.
- Establishing procedures for the receipt, retention, and treatment of complaints received by the public company regarding internal controls and auditing.

In addition, the audit committee shall have the authority to engage independent counsel or other advisors, as it determines necessary to carry out its duties.

An audit committee normally carries out these responsibilities by:

- Discussing the scope of the audit with the auditor.
- Inviting direct auditor communication on major problems encountered during the course of the audit.
- Reviewing the financial statements and discussing accounting principles, disclosures, and the auditor's report with the auditor on completion of the engagement.

In addition, the audit committee may be the primary check and balance over management discretion in financial reporting in smaller public companies. The auditor committee may review journal entries made by the CFO, accounting estimates, and the accounting for significant transactions. The audit committee also plays an important role in strengthening the auditor's ability to apply appropriate professional skepticism in an audit.

### Internal Auditors

An independent auditor ordinarily has a close working relationship with the entity's internal auditors. Management, for example, may ask the independent auditor to review the internal auditors' planned activities for the year and report

on the quality of their work. The independent auditor also has a direct interest in the work of internal auditors that pertains to the entity's system of internal control.

It is also permissible for the internal auditor to provide direct assistance to the independent auditor in performing a financial statement audit. The internal auditor's work cannot be used as a *substitute* for the independent auditor's work, but it can be an important *complement*. In determining the effect of such work on the audit, the independent auditor should (1) consider the competence and objectivity of the internal auditor and (2) evaluate the quality of the internal auditor's work. More is explained about this in Chapters 11 and 12.

### Stockholders

Stockholders rely on audited financial statements for assurance that management has properly discharged its stewardship responsibility. The auditor therefore has an important responsibility to stockholders as the primary users of the audit report. During the course of an engagement, the auditor is not likely to have direct personal contact with stockholders who are not the entity's officers, key employees, or directors. Auditors may, however, attend the annual stockholders' meeting and may be asked to respond to stockholders' questions.

### Who Is the Client?

In a public company the audit committee is responsible for selecting the auditor. However, the fact that the company pays the audit fee does not necessarily mean that the auditor should take the company's point of view. The auditor also needs to represent the interest of the public, of shareholders, and of potential shareholders, even though these individuals do not pay the audit fee. It is important for the auditor to be independent, neutral, and unbiased in performing an audit.

## LEARNING CHECK

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- 2-1 Contrast accounting and auditing as to objectives, methodology, applicable standards, and responsible parties.
- 2-2 Explain the relationship between verifiability and the concept of "fair presentation, in all material respects" in financial statements.
- 2-3 Explain the relationship between independent auditors and (1) management, (2) the board of directors and audit committee, (3) internal auditors, and (4) stockholders.
- 2-4 When performing an audit, who is the audit client?

## KEY TERMS

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Audit committees, p. 48  
 Fair presentation, p. 46  
 Management, p. 47

Material, p. 47  
 Professional skepticism, p. 47

## [AUDITING STANDARDS]

When the PCAOB was established in 2002, it was given authority to set auditing standards for auditors of public companies. In April 2003 the PCAOB adopted the generally accepted auditing standards that have been adopted by the Auditing Standards Board (ASB) of the AICPA. These 10 generally accepted auditing standards establish a framework for conducting audits, and they are not intended to provide detailed guidance for conducting audits. In many ways they are similar to the FASB Conceptual Framework that provides broad-based guidance for what should be included in financial statements, rather than specific rules or standards to be followed. The following discussion explains the 10 generally accepted auditing standards.

### Auditor Knowledge 4

■ Know the 10 generally accepted auditing standards.

### GENERALLY ACCEPTED AUDITING STANDARDS (GAAS)

The most widely recognized auditing standards associated with the public accounting profession are known as the 10 **generally accepted auditing standards (GAAS)**. These standards were originally approved by the members of the AICPA in the late 1940s. They have since been incorporated into the Statements on Auditing Standards. All of the other standards contained in the SASs are sometimes referred to as interpretations or extensions of the 10 GAAS.

The 10 GAAS are presented in Figure 2-2, which also identifies the three categories into which they are grouped. Together they establish the quality of performance and the overall objectives to be achieved in a financial statement audit. Accordingly, peers and courts of law use GAAS in evaluating the auditor's work.

#### General Standards

The general standards relate to the qualifications of the auditor and to the quality of the auditor's work. As indicated in Figure 2-2, there are three general standards.

#### Adequate Technical Training and Proficiency

Every profession puts a premium on technical competence. The competency of the auditor is determined by three factors: (1) formal university education for entry into the profession, (2) practical training and experience in auditing, and (3) continuing professional education during the auditor's professional career. The importance of the first factor is highlighted by the fact that most states require candidates for the CPA Exam to earn the equivalent of 150 semester units of college credit. Continuing professional education requirements mandated by many state boards of accountancy, the AICPA, and state societies are discussed in Chapter 1.

#### Independence in Mental Attitude

Competency alone is not sufficient. The auditor must also be free of management's influence in performing the audit and in reporting the findings. The second general standard likens the auditor's role in an audit to the role of an arbitrator in a labor dispute or a judge in a legal case. The auditor must also meet the independence requirements in the AICPA's Code of Professional Conduct as discussed in the next chapter.

Figure 2-2 ■ Generally Accepted Auditing Standards

*General Standards*

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.

*Standards of Field Work*

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of the entity and its environment, including its internal control, should be obtained to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing and extent of further audit procedures.<sup>a</sup>
3. Sufficient competent audit evidence should be obtained through audit procedures performed to afford a reasonable basis for an opinion regarding the financial statements under audit.<sup>b</sup>

*Standards of Reporting*

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

<sup>a</sup> The wording of the second field work standard was based on an Auditing Standards Board discussion draft of a proposed auditing standard dated November 2004.

<sup>b</sup> The wording of the third field work standard was based on an Auditing Standards Board discussion draft of a proposed auditing standard dated November 2004.

Source: AICPA Professional Standards.

### Due Professional Care

Just as the physician is expected to be prudent and thorough in performing a physical examination and making a diagnosis, the auditor is expected to be diligent and careful in performing an audit and issuing a report on the findings. In meeting this standard, the experienced auditor should critically review the work done and the judgments exercised by less experienced personnel who participate in the audit. The standard of due care requires the auditor to act in good faith and not to be negligent in an audit.

## Standards of Field Work

The field work standards are so named because they pertain primarily to the conduct of the audit at the entity's place of business, that is, in the field. Chapters 5 through 19 deal extensively with meeting the three standards of field work.

### Adequate Planning and Proper Supervision

For the audit to be both effective and efficient, it must be adequately planned. Planning includes the development of audit strategies and the design of audit programs for the conduct of the audit. Proper supervision is essential in an audit because staff assistants with limited experience often execute major portions of the audit programs.

### Understanding the Entity and Its Environment, Including Internal Control

A series of factors influence the risk of material misstatement, whether due to error or to fraud. This standard requires the auditor to understand:

- The entity's industry, regulatory, and other external factors.
- The nature of the entity, including its application of accounting policies.
- The entity's objectives and strategies and related business risks, as well as its risk assessment process.
- The entity's measurement and review of financial performance.
- The entity's system of internal control.

The auditor needs an understanding of the objectives, strategies, and business risks that are often correlated with the risk of material misstatement in financial statements. For example, if an entity is producing more than it is able to sell, it may have to write down inventory to its net realizable value. The entity's system of internal control is also an important factor in an audit. For example, effective internal controls should safeguard the entity's assets and produce reliable financial data. Conversely, ineffective controls may permit misappropriation of assets and result in unreliable financial information. It is essential, therefore, for the auditor to understand the entity and its environment, including its system of internal control to develop a perspective regarding the risk of material misstatement that will allow the auditor to plan an effective and efficient audit.

### Sufficient Competent Audit Evidence

The ultimate objective of this field work standard is to require the auditor to have a reasonable basis for expressing an opinion on the entity's financial statements. Meeting this standard requires the exercise of professional judgment in determining both the amount (sufficiency) and the quality (competence) of evidence needed to support the auditor's opinion.

## Standards of Reporting

In reporting the results of the audit, the auditor must meet four reporting standards.

### Financial Statements Presented in Accordance with GAAP

The first reporting standard requires the auditor to identify GAAP as the established criteria used to evaluate management's financial statement assertions. As

indicated earlier, generally accepted accounting principles include the pronouncements of authoritative bodies such as the FASB and the GASB. Special provisions for meeting this standard when a company uses a comprehensive basis of accounting other than GAAP are discussed in Chapter 20.

### Consistency in the Application of GAAP

Meeting this standard requires the auditor to explicitly refer in the auditor's report to any circumstance where GAAP have not been consistently followed in the current period in relation to the preceding period. This standard is designed to enhance the comparability of financial statements from period to period. Under this standard, when GAAP have been consistently applied there is no reference to consistency in the auditor's report.

### Adequacy of Informative Disclosures

This standard relates to the adequacy of the notes to the financial statements and other supplemental forms of disclosure. The standard has an impact on the auditor's report only when management's disclosures are inadequate. In most such cases, the auditor is required to include the necessary disclosures in the auditor's report.

### Expression of Opinion

The final reporting standard requires the auditor either to express an opinion on the financial statements taken as a whole or to state that an opinion cannot be expressed. In most audits, it is possible for the auditor to express one of several types of opinions. The different types of opinion that may be expressed are briefly explained later in this chapter and illustrated in the Appendix to Chapter 2.

## International Auditing and Assurance Standards Board (IAASB)

In 1977, 63 accountancy bodies (including the AICPA) representing 49 countries signed an agreement creating the International Federation of Accountants (IFAC). The broad objective of IFAC is "the development of a worldwide coordinated accountancy profession with harmonized standards." Toward this end, IFAC has established, as a standing subcommittee, the International Auditing and Assurance Standards Board (IAASB) with the responsibility and authority to issue International Standards on Auditing. The mission of the IAASB is to establish high-quality auditing, assurance, quality control, and related services standards and to improve the uniformity of practice by professional accountants throughout the world, thereby strengthening public confidence in the global auditing profession and serving the public interest.

Today some countries adopt IAASB standards as their own. In other countries, compliance with the international standards is voluntary, and they do not override local standards (e.g., the SASs in the United States). Where differences exist between the international standards and local standards, the local member body (e.g., the AICPA's Auditing Standards Board) is expected to give prompt consideration to such differences with a view to achieving harmonization. In recent years the U.S. Auditing Standards Board and the IAASB have worked jointly in creating auditing standards that have global acceptance. Most of the auditing principles and practices discussed in this text are consistent with IAASB standards.

## Applicability of Generally Accepted Auditing Standards

Generally accepted auditing standards are applicable in each financial statement audit made by an independent auditor regardless of the entity's size, form of business organization, type of industry, or whether the entity is for profit or not-for-profit. In April 2003 the PCAOB adopted GAAS that were in effect at that time. Thus, the standards apply equally to the audit of the financial statements of an unincorporated corner grocery store, a school district, and a large corporation such as Exxon or General Motors.

## STATEMENTS ON AUDITING STANDARDS (SAS)

**Statements on Auditing Standards (SASs)** are interpretations of generally accepted auditing standards. The Auditing and Attest Standards Team of the AICPA is responsible for establishing auditing standards for the financial statement audits of private companies. One arm of this team is the **Auditing Standards Board (ASB)**, which has been designated as the senior technical body of the AICPA to issue pronouncements on auditing standards. The ASB also is responsible for providing auditors with guidance for implementing its pronouncements by approving interpretations and audit guides prepared by the staff of the Auditing Standards Division. The ASB's 19 members represent small and large practice units, state boards of accountancy, academia, government, and the public.

Before an SAS is issued, an exposure draft of the proposed statement is widely circulated for comment to CPA firms, accounting educators, and others. The proposed statement and comments received on it are then further deliberated by the board in open meetings prior to adoption. The approval of two-thirds of the ASB members is required for issuance of an SAS. SASs explain the nature and extent of an auditor's responsibility and offer guidance to an auditor in performing the audit. Compliance with SASs is mandatory for AICPA members who must be prepared to justify any departures from such statements.

When issued, SASs and all related auditing interpretations are codified by auditing section (AU) number. Codifying SASs by AU number permits new SASs to be inserted by topic rather than in chronological order. They are then incorporated into the AICPA's looseleaf service entitled Professional Standards. Volume 1 is available in both hard copy and an electronic version on compact disks. A list of all SASs in effect when this text went to press, together with the corresponding AU section numbers, is provided on the inside back cover of this text.

## PCAOB AUDITING STANDARDS

Section 103 of the Sarbanes-Oxley Act directs the PCAOB to establish, among other things, auditing and related attestation standards to be followed by public accounting firms when auditing public companies. The **Public Companies Accounting Oversight Board (PCAOB)** is a five-member board of financially literate members. Two of those members must be (or have been) CPAs, and the remaining three members cannot be (or cannot have been) CPAs. The PCAOB's rulemaking process results in the adoption of rules that are then submitted to the Securities and Exchange Commission for approval. PCAOB rules do not take effect unless approved by the Commission. The following link provides the status of PCAOB rules as of the present time: [http://www.pcaobus.org/pcaob\\_rulemaking.asp](http://www.pcaobus.org/pcaob_rulemaking.asp).

Today there is a significant overlap between the rules of the PCAOB and the Statements on Auditing Standards. To date, the PCAOB has indicated that it reserves the right to set new auditing standards for public companies. Yet until such time as the PCAOB promulgates new auditing standards, auditors are to follow existing SASs. As a result, this text focuses on the Statements on Auditing Standards and highlights different rules that are in place for auditors of public companies. Our concern through most of this book is with generally accepted auditing standards promulgated by the AICPA for audits of private company financial statements, with appropriate modifications for the standards of the PCAOB for the audits of public company financial statements.

## LEARNING CHECK

- 2-5 What is the ASB, with what organization is it affiliated, and what is its composition?
- 2-6 What are SASs, and what is the process for their issuance?
- 2-7 What is the authority of the PCAOB with respect to setting auditing standards, and what is the process for their issuance?
- 2-8 a. Identify the three categories of generally accepted auditing standards.  
 b. Briefly indicate the subject matter of each of the 10 generally accepted auditing standards.  
 c. Does the PCAOB recognize the 10 generally accepted auditing standards?

## KEY TERMS

Auditing Standards Board (ASB),  
 p. 54  
 Generally accepted auditing  
 standards (GAAS), p. 50

Public Companies Accounting  
 Oversight Board (PCAOB), p. 54  
 Statements on Auditing Standards  
 (SAS), p. 54

## ASSURANCE PROVIDED BY AN AUDIT

### Auditor Knowledge 5

■ Understand some important auditor's responsibilities that are implied by completing the audit.

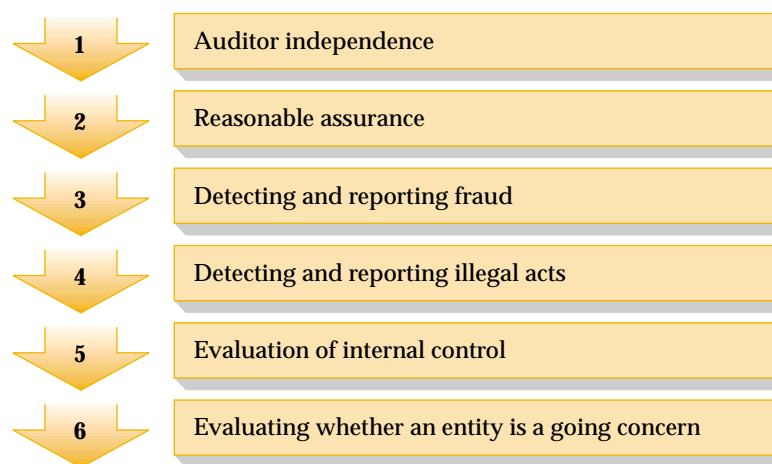
Users of audited financial statements expect auditors to:

- Perform the audit with technical competence, integrity, independence, and objectivity.
- Search for and detect material misstatements, whether intentional or unintentional.
- Prevent the issuance of misleading financial statements.<sup>2</sup>

The following discussion explains some important assurances that are provided to every financial statement user when the auditor uses the standard audit

<sup>2</sup> Report of the National Commission on Fraudulent Financial Reporting, 1987, p. 49.

Figure 2-3 ■ Key Issues Associated with the Assurance Provided by an Audit



report. Figure 2-3 provides an overview of some key issues that financial statement users should understand about the assurance provided by an audit.

### AUDITOR INDEPENDENCE

**Independence** is the cornerstone of the auditing profession. It means that the auditor is neutral about the entity and, therefore, objective. The public can place faith in the audit function because an auditor is impartial and recognizes an obligation for fairness.

Although the entity pays the auditor's fee, the CPA has a significant responsibility to known users of the auditor's report. The auditor must not subordinate his or her judgment to any specific group. The auditor's independence, integrity, and objectivity are the qualities that allow the audit to add credibility to management's assertions in the financial statements.

### REASONABLE ASSURANCE

Auditors are responsible for planning and performing an audit to obtain reasonable assurance that the financial statements are free of material misstatement. The concept of reasonable assurance, however, does not *guarantee* the accuracy of the financial statements.

The concept of **reasonable assurance** implies that audits involve tests. Auditors rarely examine 100 percent of the items in an account or transactions class. Instead, they select a portion of those items and apply procedures to them to form an opinion on the financial statements. The auditor exercises skill and judgment in deciding what evidence to look at, when to look at it, how much to look at, and who to assign to the task of collecting and evaluating particular evidence, as well as in interpreting and evaluating the results. If no evidence of material misstatement is found in these tests, the auditor concludes that the financial statements are presented fairly in accordance with GAAP.

The concept of reasonable assurance also implies that management's financial statements include accounting estimates and are not exact. GAAP requires managers to make more and more estimates of fair value. For example, managers must estimate the allowance for doubtful accounts, the net realizable value of inventory, and managers must perform impairment tests on both fixed assets and goodwill. Management and auditors must also use judgment in determining how to apply generally accepted accounting principles. The application of dollar value LIFO, for example, requires significant professional judgment. GAAP is inherently imprecise. Hence, an audit cannot guarantee financial statement accuracy, and an audit cannot increase the precision of an accounting estimate. Audits can only provide a high level of assurance, reasonable assurance, that financial statements are presented fairly in all material respects.

### DETECTING AND REPORTING FRAUD

Financial statement users expect auditors to search for and detect fraud. Fraud, however, is a broad legal concept. AU 316, *Consideration of Fraud in a Financial Statement Audit* (SAS No. 99), states that the auditor's interest specifically relates to "fraudulent acts that cause a material misstatement of the financial statements." AU 316 recognizes two types of misstatements associated with fraud: (1) misstatements arising from fraudulent financial reporting and (2) misstatements arising from misappropriation of assets.

**Fraudulent financial reporting** may involve acts such as:

- Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions, or other significant information.
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

Fraudulent financial reporting need not be the result of a grand plan or conspiracy. It may be that management rationalizes the appropriateness of a material misstatement, for example, as an aggressive rather than indefensible interpretation of complex accounting rules, or as a temporary misstatement of financial statements, including interim statements, expected to be corrected later when operational results improve.

**Misappropriation of assets** involves the theft of an entity's assets where the effect of the theft causes the financial statements not to be presented in conformity with generally accepted accounting principles. Misappropriation can be accomplished in various ways including:

- Embezzling cash or other liquid assets.
- Stealing assets.
- Causing an entity to pay for goods or services not received.

Misappropriation of assets may also be accompanied by false or misleading records or documents.

### Responsibility to Detect Fraud

The auditor's responsibility for detecting fraud is the same as the auditor's responsibility for detecting unintentional errors. First, the auditor must specifically assess

the risk of fraud in every audit, both fraudulent financial reporting and misappropriation of assets, in order to develop a knowledgeable perspective about the likely causes of fraud. The assessment of risk of material misstatement due to fraud is a cumulative process that includes a consideration of risk factors individually and in combination. The audit team will conduct a brainstorming session to evaluate the risk of material fraud, including (1) incentives and motives for fraud, (2) the opportunity to commit fraud, and (3) rationalizations that might allow someone to commit fraud. This process is discussed in more detail in Chapter 9.

Second, the auditor must plan and perform an audit to respond to identified risks and to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud. AU 316 specifically provides guidance on how the auditor responds to the risk assessment in contemplating subsequent steps in the audit and in evaluating audit test results as they relate to the risk of misstatements due to fraud.

Third, an auditor should conduct the audit with due professional care and an attitude of professional skepticism. Auditors should approach audits with a mindset that recognizes the possibility that material fraud might be present, regardless of any past experience with the entity and regardless of the auditor's belief about the integrity and honesty of management. The auditor must objectively evaluate all evidence and conditions observed during the audit. If the auditor observes indicators that are associated with a higher risk of fraud, the auditor should ensure that he or she approaches the audit with an appropriate degree of professional skepticism and collects evidence that is responsive to the risk factors observed.

### Responsibility to Report Fraud

When the auditor concludes that the financial statements are materially misstated and the financial statements are not prepared in accordance with GAAP, the auditor should insist that the financial statements be revised by management. When management agrees to make appropriate changes, the auditor can issue a standard audit report and express an unqualified opinion on the financial statements. However, if the financial statements are not revised, the auditor should appropriately modify the standard report for a departure from GAAP and disclose all substantive reasons in the audit report.

The auditor also has responsibilities for communicating the discovery of fraud to management and possibly to others. The auditor's key responsibilities for communicating the discovery of fraud are as follows:

- Whenever the auditor determines that there is evidence that even a minor fraud exists, the matter should be brought to the attention of management, generally at least one level higher than the level at which the fraud occurred.
- Any fraud involving senior management, and fraud perpetrated at any level that causes a material misstatement of the financial statements, should be reported by the auditor directly to the audit committee or board of directors.
- The auditor is generally precluded by ethical and legal obligations from disclosing fraud outside the entity. However, the auditor may be required to do so:
  - In response to a court subpoena.
  - In response to the SEC when the auditor has withdrawn or been dismissed from the engagement, or when the auditor has reported fraud or illegal acts

(defined below) to the audit committee or board of directors and the committee or board fails to take appropriate action.

- To a successor auditor who makes inquiries in accordance with professional standards.
- To a funding or other agency in accordance with audit requirements for entities that receive governmental financial assistance.

## DETECTING AND REPORTING ILLEGAL ACTS

An illegal act refers to such acts as the payment of bribes, the making of illegal political contributions, and the violation of other specific laws and governmental regulations. All U.S. companies are subject to the illegal payments provisions of the Foreign Corrupt Practices Act, which prohibits payments to foreign government officials for the purpose of obtaining or retaining business in a foreign country.

### Responsibility to Detect Illegal Acts

Two characteristics of illegal acts influence the auditor's responsibility for detection.

- The determination of whether an act is illegal is dependent on legal judgment that normally is beyond the auditor's professional competence.
- Illegal acts vary considerably in their relation to financial statements. Some laws and regulations such as income tax law have a *direct and material* effect on the provision for income tax expense and related liabilities in the financial statements. However, other laws such as those pertaining to occupations, safety, and health and to environmental protection usually have only an *indirect* effect on the financial statements (i.e., contingent liabilities).

The auditor has a different level of responsibility for two different types of illegal acts. First, AU 317.05, *Illegal Acts by Clients* (SAS 54), indicates that the auditor's responsibility for misstatements resulting from **illegal acts having a direct and material effect on the determination of financial statement amounts** is the same as that for errors or fraud. For example, a violation of tax law that results in a material misstatement of tax expense and tax liabilities would have a direct effect on the financial statements. That is, the auditor should plan an audit to detect such illegal acts that are material to the financial statements and implement the plan with due professional care. For these acts, the auditor should apply auditing procedures to ascertain whether any direct and material illegal acts have occurred. The audit should provide reasonable assurance that the financial statements are free of material misstatement owing to direct and material illegal acts.

Second, the auditor has a lower level of responsibility for **illegal acts that have an indirect effect on the financial statements**. These are all other illegal acts, and the auditor's responsibility is restricted to information that comes to the auditor's attention. Illegal acts that have an indirect effect on the financial statements, such as violating environmental law or other state or federal laws, affect the financial statements only to the degree that they result in loss contingencies. For example, if a lawsuit has been brought against an audit client, the auditor evaluates that lawsuit in the context of the accounting required by SFAS No. 5 (e.g., probability of material loss). Because of the foregoing characteristics of indirect effect illegal

acts, an audit made in accordance with GAAS provides no assurance that all such illegal acts will be detected.

Auditors develop audit plans based on risk indicators. The following indicators may indicate an increased risk of illegal acts: (1) unauthorized transactions, (2) investigations by governmental agencies, and (3) failure to file tax returns. When the auditor suspects that an illegal act has been committed, he or she should discuss the matter with an appropriate level of the entity's management and consult with the entity's legal counsel. If necessary, the auditor should also apply additional procedures to obtain an understanding of the act and its effects on the financial statements.

### Responsibility to Report Illegal Acts

The auditor's primary responsibility is for fair presentation in the financial statements. When an illegal act having a material effect on the financial statements is not properly disclosed, the auditor should insist that management revise the financial statements. If the financial statements are not appropriately revised, the auditor has a responsibility to inform financial statement users through a qualified or adverse opinion that the financial statements are not in accordance with GAAP. If the auditor is unable to obtain sufficient evidence about an illegal act, he or she should communicate this information through a qualified opinion or a disclaimer explaining the nature of the scope limitation. If management refuses to accept the auditor's report, the auditor should withdraw from the engagement and indicate the reasons to the audit committee in writing.

The auditor's responsibilities for disclosing illegal client acts to outside parties are the same as those for material fraud. In addition, the Private Securities Litigation Reform Act of 1995 imposes a requirement under certain circumstances on independent auditors of publicly held companies subject to the Securities Exchange Act of 1934. The Private Securities Litigation Reform Act of 1995 amended the 1934 Act to require the following:

- When the audit committee or board of directors of a publicly held company has been adequately informed with respect to illegal acts detected in the audit, and the auditor determines that the illegal acts have a material effect on the financial statements, and senior management or the board of directors has not taken appropriate remedial actions with respect to such illegal acts, and the failure to take remedial actions is reasonably expected to warrant departure from a standard audit report or warrant resignation by the auditor, then the auditor shall report these conclusions to the public company's board of directors.
- A public company whose board of directors receives the report referred to above must so inform the SEC not later than one business day after the receipt of such report and furnish the independent auditor with a copy of the notice provided to the SEC.
- If the independent auditor fails to receive a copy of the public company's notice to the SEC before the expiration of the required one business day period, the auditor shall, within one additional day, furnish to the SEC a copy of the report previously provided to the public company's board of directors. In such case the auditor may also wish to consider resigning from the engagement.

The amended 1934 Act further provides that no auditor shall be liable in a private action for any finding, conclusions, or statement expressed in a report made

to the SEC pursuant to the above requirement. SEC rules further provide that such reports are exempt from disclosure under the Freedom of Information Act to the same extent as are other SEC investigative records.

### EVALUATION OF INTERNAL CONTROL

The auditor's responsibility for (1) evaluating internal control over financial reporting and (2) reporting this evaluation to the shareholders and other users of financial statements is different for public companies versus private companies. The auditor of a private company reports only on the financial statements. The reader of a private company financial statement obtains *no* assurance about the system of internal control over financial reporting. A private company may have a poor system of internal control and inadequate segregation of duties, and the auditor might find material misstatements in the underlying financial records. If management adjusts the financial statements for the misstatements found by the auditor, and the revised financial statements present fairly the company's financial position, results of operations, and cash flows in all material respects, the company will receive an unqualified opinion on its financial statements.

The public company auditor has a very different responsibility. The public company auditor must perform an integrated audit that results in (1) an opinion on the financial statements, (2) an opinion on management's assessment of internal control over financial reporting, and (3) an opinion on the effectiveness of the system of internal control over financial reporting. The auditor's report on internal control over financial reporting that goes to the public must report material weaknesses in internal control. These are weaknesses in internal control that have more than a remote possibility of resulting in a material misstatement of quarterly or annual financial statements. As explained later in this chapter, if a company has a sound system of internal control in many aspects, but has one material weakness (e.g., inadequate control over disclosures regarding pension plans or derivative financial instruments), it will receive an adverse opinion that it does not have an adequate system of internal control over financial reporting. In addition, auditors must report to the audit committee significant deficiencies in internal control. A significant deficiency in internal control is a weakness in internal control that has more than a remote possibility that a misstatement of more than an inconsequential amount may occur in quarterly or annual financial statements, which is a relatively low threshold. The concept of material weaknesses and significant deficiencies is illustrated later in this chapter in Figure 2-6.

Because the auditor of a public company is now responsible for issuing three opinions, one on the financial statements and two on internal controls, this only underscores the importance of performing a high-quality audit.

### ASSURANCE ABOUT A GOING CONCERN

The primary purpose of the audit is to provide reasonable assurance that the financial statements are fairly presented in accordance with GAAP. Financial statement users must use the financial statements in making their own decisions about the risk of doing business with a company or making an investment in a company. Fair presentation is not a guarantee that an entity will continue as a going concern. Thus, the fact that an entity becomes bankrupt subsequent to the issuance of a standard audit report does not, in itself, indicate a substandard performance or audit failure by the auditor.

Nevertheless, no independent professional understands an entity's business circumstances better than the auditor. AU 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (SAS 59), provides that the auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a **going concern** for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. The concept of **substantial doubt about an entity's ability to continue as a going concern** is not mere doubt. Professional standards say that the auditor may conclude that there is substantial doubt if, for example, an entity has suffered recurring net losses and negative cash flow from operations and has defaulted on loan contracts. The audit procedures performed to evaluate a going concern are discussed in more detail in Chapter 19.

When the auditor concludes that there is substantial doubt about the entity's ability to continue as a going concern during the year following the date of the financial statements, she or he should state this conclusion in the audit report. If management includes adequate disclosures in the financial statements concerning the entity's ability to continue as a going concern, the auditor will issue an unqualified opinion on the financial statements with an additional paragraph explaining the going-concern uncertainty. If management's disclosures are considered inadequate, there is a departure from GAAP and the auditor should appropriately modify the standard report for a departure from GAAP and should therefore disclose all substantive reasons in the audit report.

Consider the following two cases. First, review the information about Enron provided in the opening vignette for Chapter 2. Although there might have been doubt about Enron's ability to continue as a going concern, the company had access to significant debt and equity markets when the auditor issued an opinion on the financial statements. Given the economic conditions at the time of the auditor's report, Andersen LLP concluded that there was not substantial doubt about Enron's ability to continue as a going concern. A significant portion of Enron's subsequent collapse was its inability to generate operating cash flow in 2001, something that was not known at the auditor's report date. Although Andersen was significantly criticized for its failure to find material misstatements in Enron's report financial position and results of operations, there have been few criticisms of the fact that it did not issue a going-concern opinion.

In a second case, Radin, Glass & Co., LLP issued a going-concern opinion on the Financial Statements of U.S. Technologies, Inc. (see Appendix 2A, p. 85, for this audit opinion) in April of 2002. At December 31, 2001, U.S. Technologies reported a \$10.8 million loss on revenues of only \$2.2 million, with cash outflow from operations of \$6.2 million. In spite of contributed capital amounting to \$59.4 million, total liabilities exceeded total assets by \$7.6 million. Note 2 to the company's financial statements addressed the going-concern issue, the capital raised during 2001, and the need to raise additional equity capital during 2002 to continue as a going concern. In this case, the auditor reached a conclusion that raised substantial doubt about the entity's ability to continue as a going concern, and management addressed the situation in a note to the financial statements. In the end, U.S. Technologies, Inc., did not make it through 2002.

### A CLEAN BILL OF HEALTH?

Some financial statement users and reporters in the media consider an auditor's standard report to constitute a clean "bill of health." For example, some users

believe that an audit endorses an entity's policy decisions, its use of resources, or the adequacy of its internal controls. This is not the case. The auditor's opinion on the financial statement does not pertain to these matters. It only pertains to whether the financial statements present fairly the entity's financial position, results of operations, and cash flows, in all material respects. A private company might have poor internal controls, and the auditor might propose audit adjustments, which management accepts, to reach the position where the financial statements fairly present financial position, results of operations and cash flows, and the company receives an unqualified opinion on its financial statements.

Other financial statement users feel that an audit provides positive assurance that a business is a safe investment and will not fail. As previously discussed, the absence of reference to substantial doubt in the auditor's report should not be viewed as providing assurance about an entity's ability to continue as a going concern.

A financial statement audit only enhances users' confidence that financial statements do not contain material misstatements because the auditor is an independent and objective expert who is also knowledgeable of the entity's business and financial reporting requirements. In the case of public companies, an audit of internal controls is also intended to enhance the user's confidence that financial statements are free of material misstatement. A public company may have financial difficulties, those difficulties may be disclosed in the financial statements, and the company may also have good internal controls over financial reporting. As a result, it might receive unqualified opinions on the financial statement and on its system of internal control over financial reporting, and yet face economic difficulties.

## LEARNING CHECK

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- 2-9 a. What is implied by the concept of reasonable assurance that the financial statements are free of material misstatement?  
b. Explain several important limitations associated with the concept of reasonable assurance.
- 2-10 a. What is the auditor's responsibility for detecting fraud while performing a financial statement audit?  
b. What is the auditor's responsibility for reporting fraud discovered during the audit to management? to the board of directors? to parties outside the entity?
- 2-11 a. What is the auditor's responsibility for detecting illegal acts while performing a financial statement audit?  
b. What is the auditor's responsibility for reporting illegal acts discovered during the audit to management? to the board of directors? to parties outside the entity?  
c. What is the auditor's potential liability to clients for reporting illegal acts to the SEC in accordance with the Private Securities Litigation Reform Act of 1995?
- 2-12 a. Explain the auditor's responsibility to evaluate the system of internal control over financial reporting for a public company.  
b. How does this differ from the auditor's responsibility to evaluate internal control for a private company?

- 2-13 What is the auditor's responsibility to report to financial statement users about an entity's ability to continue as a going concern?
- 2-14 Is an unqualified audit opinion equivalent to a "clean bill of health" for the audit client?

## KEY TERMS

Fraudulent financial reporting, p. 57	Illegal acts that have an indirect effect on the financial statements, p. 59
Going concern, p. 62	Misappropriation of assets, p. 57
Independence, p. 56	Reasonable assurance, p. 56
Illegal acts having a direct and material effect on determination of financial statement amounts, p. 59	Substantial doubt about the an entity's ability to continue as a going concern, p. 62

## THE AUDITOR'S REPORT ON FINANCIAL STATEMENTS

The audit report is the auditor's formal means of communicating with financial statement users a conclusion about the audited financial statements. In issuing an audit report, the auditor must meet the four generally accepted auditing standards of reporting. The following discussion explains the audit report, important variations of the audit report, and the assurances that are communicated to financial statement users.

### THE STANDARD REPORT ON FINANCIAL STATEMENTS

#### Auditor Knowledge 6

■ Understand the basic elements of the auditor's standard report on financial statements.

A *standard report* is the most common report issued. It contains an **unqualified opinion** stating that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with GAAS.

Because of its importance in a financial statement audit, a basic understanding of the form and content of the standard report is essential. The ASB last changed the form and content of the standard report in 1988 by issuing SAS No. 58, *Reports on Audited Financial Statements* (AU 508). This report, which has stood the test of time, was designed to better communicate to users of audited financial statements the work done by the auditor and the character and limitations of an audit. A second objective was to clearly differentiate between the responsibilities of management and the independent auditor in the financial statement audit.

An example of a standard report on comparative financial statements is presented in Figure 2-3. To the right of the sample report is a listing of the basic elements of the report. Each of these elements is prescribed in AU 508. It should be noted that the standard report has three paragraphs, which are referred to as the introductory, scope, and opinion paragraphs. Each of these paragraphs is explained in the following sections.

Figure 2-3 ■ Auditor's Standard Report on Financial Statements

<b>Basic Elements of the Auditor's Standard Report</b>	
<b>Title</b>	Includes the word "Independent"
<b>Addressee</b>	The Report is addressed to the Board of Directors and Stockholders of the entity.
<b>Introductory Paragraph</b>	<p>Identifies:</p> <ul style="list-style-type: none"> <li>• Type of service performed ("We have audited")</li> <li>• Financial statements and schedule audited</li> <li>• Entity audited</li> <li>• Dates of the statements</li> <li>• Management's responsibility for the financial statements</li> <li>• Auditor's responsibility for the opinion</li> </ul>
<b>Scope Paragraph</b>	<p>States:</p> <ul style="list-style-type: none"> <li>• The audits were conducted in accordance with the standards of the Public Companies Accounting Oversight Board. With a private company this would refer to conducting an audit in accordance with auditing standards generally accepted in the United States.</li> </ul> <p>These standards require:</p> <ul style="list-style-type: none"> <li>• Planning and performing an audit to obtain reasonable assurance that the financial statements are free of material misstatement</li> <li>• Examining evidence on a test basis</li> <li>• Assessing accounting principles used and significant estimates made by management</li> <li>• Evaluating overall financial statement presentation</li> <li>• Auditor's belief that the audit provides a reasonable basis for opinion</li> </ul> <p>Expresses auditor's opinion as to whether financial statements and schedule:</p>
<b>Opinion Paragraph</b>	<ul style="list-style-type: none"> <li>• Present fairly, in all material respects,</li> <li>• The company's financial position as of balance sheet date</li> <li>• The results of operations and cash flows for the period</li> <li>• In conformity with U.S. GAAP</li> </ul>
<b>Additional Explanatory Wording</b>	Refers to the audit of internal controls over financial reporting that was completed simultaneously with the audit of the financial statements.
<b>Firm's Signature</b>	Manual or printed signature
<b>Date</b>	Last day of field work

REPORT OF ERNST & YOUNG LLP,  
INDEPENDENT AUDITORS

To the Board of Directors and Stockholders, Intel Corporation:

We have audited the accompanying consolidated balance sheets of Intel Corporation as of December 25, 2004 and December 27, 2003, and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended December 25, 2004. Our audits also included the financial statement schedule listed in the Index at Part IV, Item 15. These financial statements and schedule are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Companies 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.

In our opinion, such consolidated financial statements present fairly, in all material respects, the consolidated financial position of Intel Corporation as of December 25, 2004 and December 27, 2003, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 25, 2004 in conformity with accounting principles generally accepted in the United States of America. Also, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respect the information set forth therein.

We also have audited with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Intel Corporation's internal control over financial reporting as of December 25, 2004, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 15, 2005 expressed an unqualified opinion thereon.

/s/ Ernst and Young LLP  
San Jose, California  
February 15, 2005

### Title and Address

Similar to the auditor's report on financial statements, the auditor's report on internal controls over financial reporting contains a title, *Report of Ernst & Young LLP, Independent Auditors*, which indicates that the auditor is independent of the company being audited. In this case the report is addressed to the board of directors and stockholders of Intel Corporation.

### Introductory Paragraph

The **introductory paragraph** of the report contains three factual statements. A primary objective of this paragraph is to clearly distinguish between the responsibility of management and the auditor. The wording of this paragraph is presented below:

We have audited the ... balance sheets ... of the X Company ... for the years then ended.

This sentence states that the auditor has audited specific financial statements of a designated company. Each of the financial statements is identified, together with the dates appropriate to each statement.

These financial statements are the responsibility of management.

This wording acknowledges that responsibility for the financial statements rests with management. Conversely, this sentence is intended to refute the notion that the auditor develops the representations underlying the financial statements.

Our responsibility is to express an opinion ... based on our audits.

This sentence specifically indicates the auditor's responsibility. The auditor's role is to conduct an audit and to express an opinion based on the findings. When read in conjunction with the second sentence, there is a clear differentiation between the responsibility of management and the responsibility of the auditor.

### Scope Paragraph

As its name suggests, the **scope paragraph** describes the nature and scope of the audit. It satisfies the portion of the fourth reporting standard that requires the auditor to give a clear-cut indication of the character of the audit. The scope paragraph also identifies several limitations of an audit. The wording of this paragraph is:

We conducted our audits in accordance with the standards of the Public Companies Accounting Oversight Board (United States).

In the report of a private company, this would refer to conducting an audit in accordance with generally accepted auditing standards. In this context, these standards include the 10 GAAS, all applicable SASs, and applicable standards of the PCAOB. This sentence asserts that the auditor has met these standards.

These standards require that we ... audit to obtain reasonable assurance ... financial statements are free of material misstatement.

This sentence identifies two significant inherent limitations of an audit. First is the acknowledgment that the auditor seeks only reasonable, rather than absolute, assurance. Thus, the reader is informed that there is some risk in an audit. Second, the concept of materiality is introduced. An audit is planned and performed to discover material, but not all, misstatements in the financial statements.

An audit includes examining, on a test basis, evidence supporting ... the financial statements.

This wording further explains another inherent limitation of an audit. The words “test basis” indicate that less than 100 percent of the evidence was examined. Furthermore, a test basis implies that there is a risk that evidence not examined may be important in assessing the fairness of the overall financial statement presentation and disclosures.

An audit also includes assessing the accounting principles ... significant estimates ... evaluating the overall financial statement presentation.

This sentence provides further insight into the character of the audit. It states that the auditor exercises judgment in assessing and evaluating management’s financial statement representations. Reference to significant estimates by management means that the financial statements are inherently imprecise.

We believe that our audits provide a reasonable basis for our opinion.

This sentence identifies another limitation of an audit by stating that only a reasonable basis is needed for an opinion. The concept of a reasonable, rather than a conclusive or absolute, basis is consistent with the concepts of test basis and reasonable assurance stated earlier in the paragraph. This sentence also contains an assertion that the auditor has formed a positive conclusion about the scope of the audit work performed.

### Opinion Paragraph

The **opinion paragraph** satisfies the four reporting standards, as explained below.

In our opinion, the financial statements referred to above...

In interpreting the meaning and significance of this clause, it is proper to conclude that the opinion is being expressed by a professional, experienced, and expert person or persons. It is incorrect, however, to conclude that this phrase says, “*We certify,*” “*We guarantee,*” or “*We are certain (or positive).*” The second part of this clause makes reference to the financial statements identified in the introductory paragraph; the titles of the individual statements are not repeated. The expression of an opinion satisfies the fourth standard of reporting.

...present fairly, in all material respects ... financial position ... results of their operations and their cash flows...

The intended connotation of the words *present fairly* is that the financial statements are presented reasonably and without bias or distortion. An auditor does not use

the words *accurately, truly, factually, correctly, or exactly* because of the existence of estimates in the financial statements. The auditor's opinion on fairness pertains to the financial statement taken as a whole. It does not apply to the accuracy or correctness of individual accounts or components of each financial statement. An unqualified opinion expresses the auditor's belief that the financial statements accomplish their stated purpose by presenting fairly the entity's financial position (balance sheet), results of operations (income and retained earnings statements), and cash flows (statement of cash flows). An unqualified opinion also means that any differences between management and the auditor on material accounting matters have been resolved to the auditor's satisfaction.

The phrase *in all material respects* informs users that the auditor's opinion does not attest to the absolute accuracy of the financial statements. This limitation is stated because of the test basis of an audit and the inclusion of significant estimates in the financial statements.

...in conformity with generally accepted accounting principles...

This clause satisfies the first standard of reporting that states the report shall indicate whether the financial statements are prepared in accordance with GAAP. The term *generally accepted accounting principles* provides the criteria for the auditor's judgment as to the fairness of the financial statements. Independent auditors agree on the existence of a body of U.S. GAAP, and these sources of GAAP are detailed in AU 411.05, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report*.

As stated earlier, the second and third standards of reporting require comment in the auditor's report only when there has been an inconsistency in applying GAAP or management has failed to make all required disclosures. Thus, in the absence of any comments on these matters in the auditor's report, the appropriate conclusion is that these two reporting standards have been met.

## DEPARTURES FROM THE STANDARD REPORT

Auditors must recognize when circumstances may arise where it is inappropriate for the auditor to issue a standard report. Departures from the standard report fall into the following categories:

- Standard report with explanatory language.
- Other types of opinions
  - Qualified opinion
  - Adverse opinion
  - Disclaimer of opinion

The following discussion explains when auditors should use these various auditor reports.

### Standard Report with Explanatory Language

The distinguishing characteristic of this category of reports is that the opinion paragraph continues to express an unqualified opinion because the financial statements present fairly an entity's financial position, results of operations, and cash

#### Audit Decision 1

■ When should the auditor use a non-standard report on financial statements?

flows in conformity with GAAP. However, the following circumstances require the auditor to add an **explanatory paragraph** or other explanatory language to the standard report. The auditor should use this option when:

- An entity elects to make a change in accounting principles from one acceptable method to another (see p. 86).
- The auditor reaches a conclusion that substantial doubt exists about the entity's ability to continue as a going concern (see p. 85).
- The auditor wishes to emphasize information contained in the notes to the financial statements, such as a related party transaction (see p. 88).

In addition, the auditor will modify the language of the audit report when a significant aspect of the audit relies on the audit work and opinion of another auditor.

Although the explanatory information is usually provided in an explanatory paragraph following the opinion paragraph, in some cases it merely involves the addition of explanatory wording within the three standard paragraphs, and in rare cases an explanatory paragraph is added before the opinion paragraph. Examples of these reports that contain unqualified opinions on the financial statements are presented in Appendix 2A.

### OTHER TYPES OF OPINIONS

The second category of departures results when either of the following circumstances occurs:

- The financial statements contain a material departure from GAAP.
- The auditor has been unable to obtain sufficient competent evidence regarding one or more of management's assertions and as a result does not have a reasonable basis for an unqualified opinion on the financial statements as a whole.

In these cases, the auditor will express one of the following types of opinions:

- A **qualified opinion**, which states that except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly ... in conformity with GAAP.
- An **adverse opinion**, which states that the financial statements do not present fairly ... in conformity with GAAP.
- A **disclaimer of opinion**, which states that the auditor does not express an opinion on the financial statements.

**Departures from GAAP** include using accounting principles that are not generally accepted, misapplying GAAP, and failing to make disclosures required by GAAP. For example, an entity might misapply GAAP by making an accounting estimate that materially misstates an entity's financial position and results of operations. Alternatively, if an entity's financial statements reflect a change in accounting principles that was not made in accordance with APB Opinion No. 20, the statements contain a departure from GAAP. In these circumstances, the auditor will express a *qualified opinion* if there is a material departure from GAAP (see p. 89) or an *adverse opinion*, if in the auditor's judgment the departure from GAAP has an extremely material effect on the financial statements (see p. 91).

A **scope limitation** occurs when the auditor has been unable to obtain sufficient competent evidence to verify whether one or more assertions are in conformity with

GAAP. In these cases, the auditor will issue a *qualified opinion* when circumstances impose a material scope restriction (see p. 90). For example, an auditor might be engaged after the beginning of the year and is unable to observe the existence of beginning inventories that would impact a conclusion about financial position (beginning inventory) and results of operations (cost of goods sold). Alternatively an auditor engaged to audit only the balance sheet for a company being acquired might find that the company has inadequate records of the cost of fixed assets, but otherwise the auditor is able to obtain sufficient competent evidence about financial position.

An auditor will use a *disclaimer of opinion* when an entity imposes a material scope restriction (such as preventing the auditor from obtaining sufficient competent evidence related to one or more of management's assertions in the financial statements) or when a scope limitation pertains to matters that could have an extremely material effect on the statements (see p. 92).

Whenever one of these other types of opinions is expressed, the reason(s) for the opinion should be explained in one or more explanatory paragraphs immediately before the opinion paragraph. The opinion paragraph then begins with a reference to the explanatory paragraph(s), followed by wording appropriate to the type of opinion being expressed (qualified opinion, adverse opinion, or disclaimer of opinion).

A summary of the types of auditors' reports discussed in this chapter, the circumstances when each is appropriate, and a typical profile for each type of report is presented in Figure 2-4. It should be noted that this summary does not include all variations of audit reports. The page numbers in Figure 2-4 refer to illustrations of the types of reports in Appendix 2A. Illustrative examples of the reports, an explanation of what they mean, and a discussion of the auditor's criteria for using the report are provided.

## LEARNING CHECK

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- 2-15 a. What are the seven basic elements of the auditor's standard report?  
b. What is the significance of the date of the auditor's standard report?
- 2-16 How is compliance with the four standards of reporting of GAAS indicated in the auditor's standard report?
- 2-17 a. Identify two categories of departures from the auditor's standard report.  
b. Identify three types of circumstances that require a departure from the auditor's standard report and indicate the type or types of opinion appropriate for each.
- 2-18 State the wording in the opinion paragraph that differentiates each of the four types of opinions that may be expressed.

## KEY TERMS

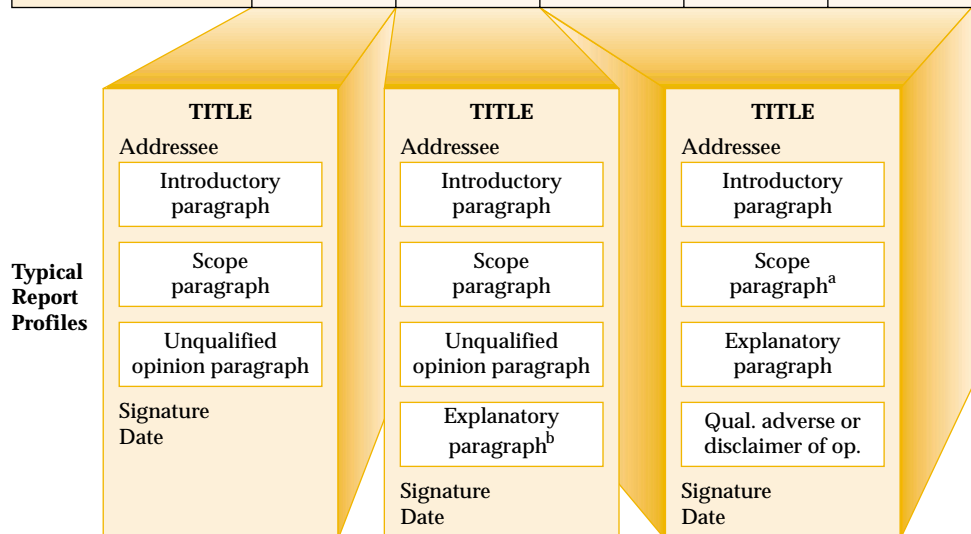
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Adverse opinion, p. 69  
 Departures from GAAP, p. 69  
 Disclaimer of opinion, p. 69  
 Explanatory paragraph, p. 69  
 Introductory paragraph, p. 66

Opinion paragraph, p. 67  
 Qualified opinion, p. 69  
 Scope limitation, p. 69  
 Scope paragraph, p. 66  
 Unqualified opinion, p. 64

Figure 2-4 ■ Types of Auditors' Reports and Circumstances

Circumstance	Standard Report	Departures from Standard Report				
		Unqualified Opinion	Standard Report with Explanatory Language	Other Types of Opinions		
			Unqualified Opinion	Qualified	Adverse	Disclaimer
<b>Financial statements conform to GAAP, audit completed in accordance with GAAS, and:</b> <ul style="list-style-type: none"> <li>• Circumstances requiring explanatory language do not exist.</li> <li>• Circumstances requiring explanatory language exist (e.g., accounting change or going concern).</li> </ul>	✓ p. 65					
		✓ pp. 85–88				
Financial statements contain a <b>departure from GAAP</b> >			✓ Material p. 89	✓ Extremely material and pervasive p. 91		
Auditor unable to obtain sufficient competent evidence ( <b>scope limitation</b> )			✓ Material p. 90		✓ Extremely material p. 92	



<sup>a</sup> Scope paragraph omitted for disclaimer of opinion.

<sup>b</sup> Explanatory paragraph located before opinion paragraph in rare cases.

## THE AUDITOR'S REPORT ON INTERNAL CONTROL

The major difference between the audit of a privately held company and that of a public company is that auditors of public companies must perform a combined audit that results in two reports. First, public company auditors report on management's financial statements as discussed in the preceding section. Second, auditors report on internal control over financial reporting.

### THE STANDARD REPORT

#### Auditor Knowledge 7

■ Understand the basic elements of the auditor's standard report on internal controls over financial reporting.

A *standard report* is the most common report issued. It contains an unqualified opinion stating that management's assertion about its system of internal control is fairly stated in all material respects. This conclusion may be expressed only when the auditor has identified no material weaknesses in internal control over financial reporting and when there have been no restrictions on the scope of the auditor's work. The auditor should form an opinion on the basis of an audit performed in accordance with the professional practice standards established by the PCAOB.

The standard report on internal control received by Intel Corporation is presented in Figure 2-5. To the right of the sample report is a listing of the basic elements of the report. Each of these elements is prescribed in the standards of the PCAOB. It should be noted that the standard report has five paragraphs, which are referred to as the introductory paragraph, definition, scope, inherent limitations, and opinion paragraphs as explained below.

Finally, Section 404 of the Sarbanes-Oxley Act of 2002 addresses reporting on internal controls only over financial reporting. A company may also have internal controls that relate to compliance with laws and regulations or effective and efficient utilization of assets. This report on internal controls only addresses internal control over financial reporting, and other controls are not covered by the scope of this audit. **Internal control over financial reporting** is defined in the definition paragraph of the auditor's report (see below).

### Title and Address

Similar to the auditor's report on financial statements, the auditor's report on internal controls over financial reporting contains a title, *Report of Ernst & Young LLP, Independent Auditors*, which indicates that the auditor is independent of the company being audited. The report is usually addressed to the board of directors and stockholders.

### Introductory Paragraph

The introductory paragraph of the report contains three factual statements. The primary objective of this paragraph is to identify what has been audited and to clearly distinguish between the responsibility of management and that of the auditor. The wording of this paragraph is presented below:

We have audited management's assessment, included in the accompanying [title of management's report] that Intel Corporation maintained effective internal control over financial reporting as of December 25, 2004, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Figure 2-5 ■ Auditor's Standard Report on Internal Control over Financial Reporting

<p>REPORT OF ERNST &amp; YOUNG, LLP, INDEPENDENT AUDITORS</p> <p>To the Board of Directors and Stockholders, Intel Corporation:</p> <p>We have audited management's assessment, included in the accompanying Management Report on Internal Control over Financial Reporting that Intel Corporation maintained effective internal control over financial reporting as of December 25, 2005, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Intel Corporation is responsible for its assessment about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.</p> <p>We conducted our audit in accordance with auditing and related professional practice standards established by the standards of the Public Companies Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective control over financial reporting was maintained in all material respects. Our audits included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.</p> <p>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.</p> <p>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 control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.</p> <p>In our opinion, management's assessment that Intel Corporation maintained effective internal control over financial reporting as of December 25, 2004, is fairly stated, in all material respects, based on the COSO criteria. Also in our opinion Intel Corporation maintained, in all material respects, effective internal control over financial reporting as of December 25, 2004 based on the COSO criteria .</p> <p>We have also audited, in accordance with the standards of the Public Companies Accounting Oversight Board (United States), the 2004 consolidated financial statements of Intel Corporation and our report dated February 15, 2005 expressed an unqualified opinion on those financial statements.</p> <p>/s/ Ernst and Young LLP San Jose, California February 15, 2005</p>		<p><b>Basic Elements of the Auditor's Standard Report</b></p> <p>Includes the word "Independent" The Report is addressed to the Board of Directors and Stockholder's of the entity.</p> <p>Identifies:  <ul style="list-style-type: none"> <li>• Type of service performed ("We have audited")</li> <li>• Management's assertion that it maintained an effective system of internal control was audited</li> <li>• Name of entity audited</li> <li>• Dates of the assertion regarding internal control</li> <li>• Management's responsibility for the assertion</li> <li>• Reference to COSO criteria for internal control</li> <li>• Auditor's responsibility for the two opinions</li> </ul> </p> <p>States that the audit was conducted in accordance with the standards of the Public Companies Accounting Oversight Board. These standards require:  <ul style="list-style-type: none"> <li>• Planning and performing an audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained, in all material respects</li> <li>• Understanding the system of internal control over financial reporting</li> <li>• Evaluating the effectiveness of its design</li> <li>• Evaluating its effective operation</li> <li>• Auditor's belief that the audit provides a reasonable basis for the opinion</li> </ul> </p> <p>The purpose of internal control over financial reporting is to provide:  <ul style="list-style-type: none"> <li>• Reasonable assurance</li> <li>• Over the reliability of financial reporting and the preparation of financial statements in accordance with GAAP.</li> </ul> </p> <p>Three aspects of internal control over financial reporting:  <ol style="list-style-type: none"> <li>1. Maintain records of transactions in reasonable detail</li> <li>2. Provide reasonable assurance that transactions are recorded to permit preparation of financial statements in accordance with GAAP, and all receipts and expenditures are authorized</li> <li>3. Provide reasonable assurance regarding prevention, or timely detection, of unauthorized acquisition, use or disposition of the company's assets that are material in the context of the financial statements.</li> </ol> </p> <p>Inherent limitations may prevent the system of internal control over financial reporting from being 100% effective. Explains the risk that internal controls may not function in the future as they have in the past.</p> <p>Expresses auditor's opinion as to whether <i>management's assertion</i> about internal controls over financial reporting financial statements:  <ul style="list-style-type: none"> <li>• Present fairly, in all material respects,</li> <li>• As of balance sheet date</li> <li>• In conformity with COSO criteria</li> </ul>                 Also expresses the auditor's opinion that the company maintained effective internal control over financial reporting.             </p> <p>States that the auditor also audited the financial statements of the company, identifies the financial statements, and states the opinion expressed on the financial statements.</p>
<p>Title Addressee</p> <p>Introductory Paragraph</p> <p>Scope Paragraph</p> <p>Definition Paragraph</p> <p>Inherent Limitations Paragraph</p> <p>Opinion Paragraph</p> <p>Explanatory Paragraph</p>	<p>Firm's Signature Date</p> <p>Manual Signature City and State or Country Last day of field work</p>	

This sentence states that the CPA firm has audited management's assessment of the effectiveness of internal control over financial reporting included in management's report as of December 25, 2004. Note that management is making an assertion that internal control was effective as of the last day of the fiscal year. Performing all of the testing on December 25, however, is neither practical nor appropriate. PCAOB standards suggest that auditors obtain evidence about operating effectiveness at different times throughout the year, provided that the auditor updates those tests or obtains other evidence that the controls continued to operate effectively at the end of the company's fiscal year. Also note that the criteria for judging the effectiveness of internal control are the criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). These criteria are discussed further in Chapter 10.

Intel Corporation is responsible for its assessment about the effectiveness of internal control over financial reporting.

This wording acknowledges that responsibility for the assessment of internal control over financial reporting rests with management. Conversely, this sentence is intended to refute the notion that the auditor develops the representations about internal control over financial reporting.

Our responsibility is to express an opinion on management's assessment based on our audit.

This sentence specifically indicates the auditor's responsibility. The auditor's role is to make an audit and to express an opinion based on the findings. When read in conjunction with the second sentence, there is a clear differentiation between the responsibility of management and the responsibility of the auditor.

### Scope Paragraph

As its name suggests, the scope paragraph describes the nature and scope of the audit and identifies several limitations of an audit. The wording of this paragraph is:

We conducted our audit in accordance with auditing and related professional practice standards established by the standards of the Public Companies Accounting Oversight Board (United States).

This sentence asserts that the auditor has met the standards established by the PCAOB.

Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective control over financial reporting was maintained in all material respects.

This sentence identifies two significant inherent limitations of an audit. First is the acknowledgment that the auditor seeks only reasonable, rather than absolute, assurance. Thus, the reader is informed that there is some risk in an audit. Second,

the concept of materiality is introduced. An audit is planned and performed to discover deficiencies in internal control over financial reporting that could lead to material, but not all, misstatements in the financial statements.

Our audits included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances.

This wording further explains another inherent limitation of an audit. The words *testing and evaluating* indicate that less than 100 percent of the possible evidence about internal control was examined. Furthermore, testing implies that there is a risk that evidence not examined may be important in assessing the fairness of the conclusion about internal control.

We believe that our audit provides a reasonable basis for our opinion.

This sentence identifies another limitation of an audit by stating that only a reasonable basis is needed for an opinion. The concept of a reasonable, rather than a conclusive or absolute, basis is consistent with the concepts of test basis and reasonable assurance stated earlier in the paragraph. This sentence also contains an assertion that the auditor has formed a positive conclusion about the scope of the audit work performed.

### Definition Paragraph

This paragraph defines internal control over financial reporting. The first sentence states the purpose of internal control over financial reporting.

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.

An important aspect of this definition is that it addresses the concept of reasonable assurance. When auditing either internal control or financial statements, the concept of reasonable, not absolute, assurance is central. A guarantee of the accuracy of management's assertion is not possible.

The paragraph then goes on to define internal control over financial reporting by three important goals. It represents 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 expenditure of the company are being made only in accordance with authorizations of management and directors of the company.
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.

## Inherent Limitations Paragraph

The inherent limitations paragraph states:

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 control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The inherent limitations paragraph addresses the fact that the company's system of internal control may not always prevent or detect misstatements. Although not specifically stated in this paragraph, the types of inherent limitations that prevent internal control over financial reporting from being effective include:

- Mistakes in judgment when applying internal control.
- Breakdowns and fatigue. Many aspects of internal control are human processes that may function inconsistently over time. They may function at a very high level but not work perfectly.
- Collusion between individuals may cause segregation of duties to break down, and internal controls may appear to function when they are not.
- Management override. Senior management may have authority that would cause otherwise functioning internal controls to break down. Auditors must assess the risk of management override, but that risk might not be reduced to zero.

Because inherent limitations are known features of the financial reporting process, it is possible to design systems to reduce, but not eliminate, the risk associated with such limitations.

Finally, the paragraph clearly states that while internal control over financial reporting might have functioned effectively in the past, there is a very real risk that it may not function as effectively in the future, and the auditor's opinion does not address the likelihood of the system functioning in future periods as effectively as it did in the past.

## Opinion Paragraph

The opinion paragraph provides the auditor's conclusion about management's assertion regarding internal control over financial reporting. It is structured similar to the opinion paragraph in the auditor's report on financial statements.

In our opinion,...

In interpreting the meaning and significance of this clause, it is proper to conclude that the opinion is being expressed by a professional, experienced, and expert person or persons. It is incorrect, however, to conclude that this phrase says, "*We certify,*" "*We guarantee,*" or "*We are certain (or positive).*"

...management's assertion that Intel Corporation maintained effective internal control over financial reporting as of December 25, 2004 is fairly stated, in all material respects, based on the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

This clause makes reference to management's assessment about effective internal control over financial reporting. The intended connotation of the words *fairly stated* is that management's assertion is presented reasonably and without material bias or distortion. An auditor does not use the words *accurately*, *factually*, *correctly*, or *exactly* because of the inherent limitations of a system of internal control. The auditor's opinion on fairness pertains to management's assertion about the evaluation of internal control and to whether the auditor agrees with management's assertion. Finally, the auditor's report makes reference to the established criteria for evaluating internal control over financial reporting, which is the COSO criteria published in *Internal Control-Integrated Framework*. This framework is discussed in detail in Chapter 10.

Also, in our opinion, Intel Corporation maintained, in all material respects, effective internal control over financial reporting as of December 25, 2004, based on the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

The auditor's opinion on internal control over financial reporting is a dual opinion. In this sentence, the auditor provides an opinion on the adequacy of the system of internal control itself. In order to receive an unqualified opinion, the auditor must conclude that there are no material weaknesses in the system of internal control over financial reporting. As discussed below, the company may have significant deficiencies in internal control over financial reporting, which are reported to the audit committee, and still receive an unqualified opinion on internal control. This is discussed further in the next section on departures from the standard report. This sentence expresses the auditor's opinion that Intel Corporation established an effective system of internal control over financial reporting.

### Explanatory Paragraph

The explanatory paragraph describes the fact that the auditor performed both an audit of internal controls and an audit of the financial statements as stated below.

We have also audited, in accordance with the standards of the Public Companies Accounting Oversight Board (United States), the balance sheet of Intel Corporation as of December 25, 2004 and December 27, 2003 and related statements of income, cash flows, and equity for the three years then ended, and our report dated January xx, 2005 expressed an unqualified opinion on those financial statements.

The paragraph identifies the financial statements that were audited, the date of the audit report, and the opinion that was issued. Normally, users would expect that the opinion would be an unqualified opinion and the date of the audit report would be the same as the date of the report on internal controls. This statement is important to users as they can infer that the opinion on internal controls was informed by the audit work that supported the opinion on the financial statements.

### Signature and Date

The engagement partner should manually sign the auditor's report. The date, as with the date on the auditor's report, represents the date that the auditor com-

pleted the process of obtaining evidence to form an opinion about management’s assertion regarding internal control over financial reporting. This is called the last day of field work.

### DEPARTURES FROM THE STANDARD REPORT

An auditor will depart from the standard report when a material weakness in internal control over financial reporting exists. Two important definitions are relevant here.

**Audit Decision 2**  
 ■ When should the auditor use a non-standard report on internal controls over financial reporting?

- A **significant deficiency** is an internal control deficiency that adversely affects the company’s ability to initiate, authorize, record, process, or report external financial data reliably in accordance with GAAP. A significant deficiency could be a single deficiency, or a combination of deficiencies, that results in more than a remote likelihood that a misstatement of the annual or interim financial statements that is more than inconsequential in amount will not be prevented or detected.
- A **material weakness** is a significant deficiency that, by itself, or in combination with other significant deficiencies, results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

The auditor should evaluate the significance of a deficiency in internal control over financial reporting by initially determining (1) the likelihood that a deficiency could result in a misstatement of an account balance or disclosure and (2) the magnitude of the potential misstatement resulting from the deficiency or deficiencies. The significance of a deficiency in internal control over financial reporting depends on the potential for a misstatement, not on whether a misstatement has actually occurred. Figure 2-6 provides an example of how an auditor might quantify the difference between a deficiency in internal control, a significant deficiency in internal control, and a material weakness. However, these differences are a matter of professional judgment, and auditors might use criteria that are different from those illustrated in this figure.

Figure 2-6 ■ Example Criteria for Evaluating a Deficiency in Internal Control

	Likelihood of Misstatement	Magnitude of Potential Misstatement
<b>Internal Control Deficiency</b>	Remote (less than a 5 to 10% chance <sup>a</sup> )	Inconsequential (less than 0.5 to 1% of pretax income <sup>a</sup> )
<b>Significant Deficiency</b>	More than remote (more than a 5 to 10% chance <sup>a</sup> )	More than inconsequential (more than 0.5 to 1% of pretax income <sup>a</sup> )
<b>Material Weakness</b>	More than remote (more than a 5 to 10% chance <sup>a</sup> )	Material (more than 4 to 5% of pretax income <sup>a</sup> )

<sup>a</sup> Quantifications are a matter of professional judgment, and auditors might use criteria that are different from those illustrated in this figure.

The PCAOB standards indicate that the following circumstances should be regarded as at least a significant deficiency and is a strong indicator that a material weakness in internal control over financial reporting exists.

- Restatement of previously issued financial statements to reflect the correction of a misstatement.
- Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting. This is still a strong indicator of a material weakness, even if management subsequently corrects the misstatement.
- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.
- For larger, more complex entities, an ineffective internal audit or risk assessment function.
- For complex entities in highly regulated industries, an ineffective regulatory compliance function.
- Identification of fraud of any magnitude on the part of senior management.
- Significant deficiencies that have been communicated to management and the audit committee, remain uncorrected after a reasonable period of time.

Figure 2-7 identifies some common circumstances when an auditor should depart from the standard report on internal control over financial reporting, and the type of opinion that the auditor should use.

### Material Weakness in Internal Control over Financial Reporting

If there are significant deficiencies that, individually or in combination, result in one or more material weaknesses, management is precluded from concluding that internal control over financial reporting is effective. In these circumstances, the auditor must express an adverse opinion on the effectiveness of the company's internal control over financial reporting. The key aspects of this report would describe the material weakness in internal control over financial reporting in an explanatory paragraph, and the auditor's opinion would state that the company has not maintained effective internal control over financial reporting. This is the case even if there is only one material weakness (e.g., inadequate internal control over disclosures about derivative financial instruments) and the balance of the system of internal control over financial reporting is considered to be effective.

Readers must also understand that it is possible for the auditor to render an adverse opinion on the effectiveness of internal control over financial reporting and issue an unqualified opinion on the financial statements. For example, the auditor might identify the possibility of a material misstatement due to inadequacies in internal control that results in a material weakness. However, in performing audit procedures the auditor determined that the financial statements were not materially misstated. Or perhaps material misstatement was found and corrected by the entity. If a material weakness in internal control existed, it would result in an adverse opinion on internal control, but since the financial statements were presented fairly the auditor can issue an unqualified opinion on the financial statements.

Figure 2-7 ■ Departures from the Standard Report on Internal Control over Financial Reporting

Circumstances	Opinion
<p>A material weakness exists in internal controls. For example, the auditor may have identified a material misstatement in the financial statements in the current period that was not initially identified by the company's internal control over financial reporting. Users should also understand that a company may get an adverse opinion on the effectiveness of its system of internal control, even if it has only one material weakness.</p>	<p>Adverse opinion</p>
<p>A significant deficiency in internal controls exists. For example, the auditor might have identified a deficiency in internal controls over revenue recognition. In the auditor's opinion, the significant deficiency could result in more than a remote likelihood that a misstatement of the annual or interim financial statements that is more than inconsequential in amount (but less than material) will not be prevented or detected. The auditor reports this to management and the audit committee.</p>	<p>Unqualified opinion</p>
<p>Circumstance imposed scope limitation. For example, the auditor might have identified a material weakness at an interim date, and the entity implements new controls to correct the deficiency. However, if the new controls are placed in operation near year-end, the auditor may not have sufficient time to determine that they actually are operating effectively at fiscal year-end.</p>	<p>Withdraw or disclaim opinion or qualified opinion</p>
<p>Management imposes a scope limitation. For example, in a multi-location audit the entity imposes a restriction on visiting certain locations that are important to the scope of the audit.</p>	<p>Withdraw or disclaim opinion</p>

### Significant Deficiency in Internal Control over Financial Reporting

Auditors may find what they believe are significant deficiencies that do not result in one or more material weaknesses in the financial statements. Auditors have a responsibility to report all significant deficiencies, weaknesses that might result in misstatements that are more than inconsequential in amount, to management and the audit committee. If significant deficiencies do not aggregate to a level of material weaknesses, the auditor can make a statement that management has an effective system of internal control over financial reporting. Nevertheless, because of the responsibility to report all significant deficiencies to the audit committee, some auditors describe the auditor's responsibility for internal control as one where the auditor has a high responsibility for a low threshold of internal control weaknesses.

### Scope Limitations

The auditor can express an unqualified opinion on internal control over financial reporting only if the auditor has been able to apply all the procedures nec-

essary under the circumstances. If there are restrictions on the scope of the engagement imposed by the circumstance surrounding the audit, the auditor should choose among withdrawing from the engagement, disclaiming an opinion, or expressing a qualified opinion. The auditor's decision depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on the effectiveness of the company's internal control over financial reporting. Furthermore, the standards of the PCAOB state that when the restrictions are imposed by management, the auditor should withdraw from the engagement or disclaim an opinion on the effectiveness of internal control over financial reporting.

Figure 2-6 provides several examples of scope restrictions. A common scope restriction occurs when a material weakness is identified prior to the date specified in the report and management implements controls to correct the deficiency. In some cases the new control may be placed in operation for such a short period of time that the auditor cannot draw a conclusion about the effectiveness of operation of the control. In this case the auditor should modify the opinion because of a scope limitation.

### Are Companies Ready for Audits of Their Internal Controls over Financial Reporting?

In 2003 the Financial Executives Institute surveyed CFOs and other senior financial executives about their readiness for audits of internal controls over financial reporting and the cost of complying with Sarbanes-Oxley Act Section 404 audits of internal control. According to the survey, only 25 percent of respondents said that they had deployed a permanent solution to Section 404 requirements. Many companies, particularly smaller public companies, are not ready. As a result, the PCAOB pushed back their effective dates beyond the proposed effective date in the standards that they originally exposed for comment. The new effective dates are such that generally, a company that has equity market capitalization over \$75 million will have to comply with these rules for fiscal years ending after November 15, 2004. Smaller companies will not have to have audits of their system of internal control over financial reporting until their first year-end after July 15, 2005.

## LEARNING CHECK

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- 2-19 a. What are the nine basic elements of the auditor's standard report on internal control over financial reporting?
- b. What is the significance of the date of the auditor's standard report?
- c. What are the professional standards that govern the audit of management's assertion regarding the effectiveness of internal control over financial reporting?
- 2-20 a. Define internal control over financial reporting.
- b. What aspects of a company's overall system of internal control are not included as part of internal control over financial reporting?
- 2-21 Describe the inherent limitations of internal control over financial reporting.

- 2-22 a. When should an auditor issue an adverse opinion on internal controls over financial reporting?
- b. Provide an example of a scope limitation and explain the criteria an auditor should use when making a decision about when either to withdraw from an engagement or issue a disclaimer of opinion or a qualified opinion because of a scope limitation.
- c. Explain why an auditor might issue an adverse opinion on internal controls over financial reporting and issue an unqualified opinion on the financial statements.

## KEY TERMS

Internal control over financial reporting, p. 72, 75

Material weakness, p. 78  
Significant deficiency, p. 78

## FOCUS ON AUDITOR KNOWLEDGE AND AUDIT DECISIONS

This chapter introduces some basic knowledge about the assurance provided by an audit. It also explains the reports used to communicate results to financial statement users. Figures 2-8 and 2-9 summarize the important components of auditor knowledge and key audit decisions discussed in this chapter. Page references to a detailed discussion of these issues are provided.

Figure 2-8 ■ Summary of Auditor Knowledge Discussed in Chapter 2

Auditor Knowledge	Summary	Chapter References
K1. Know the relationship between accounting and auditing.	Accounting involves the process of identifying, measuring, recording, classifying, summarizing, and reporting events that affect an entity in financial statements. Management is responsible for reporting and disclosing events and transactions in its financial statements. Auditing involves gathering evidence to obtain reasonable assurance that the financial statements are presented fairly in all material respects. Auditors are responsible for their report on fair presentation in the financial statements.	pp. 44–46
K2. Understand how the concept of verifiability relates to the concept of “fair presentation, in all material respects.”	Accounting requires the application of significant professional judgment, and the imprecision in accounting leads to an imprecision in the ability to verify financial statement presentations. Hence, the auditor seeks only a reasonable basis for expressing an opinion on the fairness of the financial statements.	pp. 45–47

*(table continues)*

Figure 2-8 ■ (Continued)

Auditor Knowledge	Summary	Chapter References
K3. Understand the auditor's relationship with management, the board of directors, the audit committee, and other groups.	Auditors have differing relationships with management, the board of directors and audit committee, internal auditors, and stockholders. These relationships are explained in the chapter. The auditor must work particularly closely with management but must also approach this relationship with an appropriate level of professional skepticism.	pp. 47–49
K4. Know the 10 generally accepted auditing standards.	Generally accepted auditing standards are divided into three groups: general standards, field work standards, and reporting standards. The general standards address the auditor's (1) technical training and proficiency, (2) independence, and (3) use of due professional care. The field work standards address (1) audit planning, (2) evaluation of the entity and its environment, including internal controls, and (3) obtaining sufficient, competent evidence. The reporting standards address (1) whether the financial statements conform to GAAP, (2) whether accounting principles used are consistent with those used in the previous years, (3) the adequacy of disclosures, and (4) the expression of an opinion by the auditor.	pp. 50–55
K5. Understand some important auditor's responsibilities that are implied by completing the audit.	This section of the chapter explains the concept of reasonable assurance. Auditors must use professional judgment when making decisions regarding the selection of evidence to support an opinion on the financial statements. The section also discusses the auditor's responsibility for detecting and reporting both fraud and illegal acts. Finally, it addresses the auditor's annual responsibility for evaluating an entity's system of internal control and when substantial doubt may exist about whether an entity is a going concern.	pp. 55–63
K6. Understand the basic elements of the auditor's standard report on financial statements.	The standard audit report includes the following elements that are explained in detail in the chapter; (1) the title and addresses, (2) the introductory paragraph, (3) the scope paragraph, (4) the opinion paragraph, (5) and the firm's signature and report date.	pp. 64–68
K7. Understand the basic elements of the auditor's standard report on internal controls over financial reporting.	Auditors of public companies must perform a combined audit of the financial statements and of the entity's internal control over financial reporting. The standard audit report includes the following elements that are explained in detail in the chapter: (1) the title and addresses, (2) the introductory paragraph, (3) the definition paragraph, (4) the scope paragraph, (5) the inherent limitations paragraph, (6) the opinion paragraph, (7) and the firm's signature and report date.	pp. 72–78

Figure 2-9 ■ Summary of Audit Decisions Discussed in Chapter 2

Audit Decision	Factors that Influence the Audit Decision	Chapter References
D1. When should the auditor use a nonstandard report on financial statements?	<p>Circumstances in which the auditor would use an unqualified opinion with additional explanatory wording.</p> <ul style="list-style-type: none"> <li>• The entity changes from one acceptable accounting principle to another.</li> <li>• The auditor has substantial doubt about the entity's ability to continue as a going concern.</li> <li>• The auditor wishes to emphasize information.</li> <li>• The auditor relies on the audit work and audit opinion of another auditor.</li> </ul> <p>Circumstances in which the auditor would use a qualified opinion.</p> <ul style="list-style-type: none"> <li>• The financial statements contain a material departure from GAAP.</li> <li>• Circumstances impose a material scope restriction.</li> </ul> <p>Circumstances in which the auditor would use an adverse opinion.</p> <ul style="list-style-type: none"> <li>• The financial statements contain such an extremely material departure from GAAP that the financial statements do not present fairly financial position, results of operations, or cash flows.</li> </ul> <p>Circumstances in which the auditor would use a disclaimer of opinion.</p> <ul style="list-style-type: none"> <li>• Circumstance imposes an extremely material scope restriction, or the client imposes a material scope restriction.</li> </ul>	pp. 68–71
D2. When should the auditor use a nonstandard report on internal controls over financial reporting?	<p>The auditor would issue an adverse opinion on internal controls over financial reporting if a material weakness in internal controls is identified.</p> <p>Client-imposed scope restriction may cause the auditor to disclaim opinion or withdraw from the engagement.</p> <p>Circumstance-imposed scope restriction might cause the auditor to issue a qualified opinion or disclaim opinion. If the circumstances are sufficiently severe, the auditor may consider withdrawing from the engagement.</p>	pp. 78–81

### appendix 2a

#### EXAMPLE DEPARTURES FROM THE STANDARD AUDIT REPORT

Following are a variety of examples of departures from the standard auditor's report. Each example is accompanied by an explanation of (1) what the report means for financial statement users and (2) the auditor's criteria for using the report.

**Unqualified Opinion on the Financial Statements with Explanatory Language regarding Going Concern:** The following opinion was issued by Radin, Glass & Co., LLP on April 10, 2002 with respect to the financial statements for U.S. Technologies, Inc. for the years ended December 31, 2001 and 2000. **Note: The portions of the auditor's report that differ from the standard, three-paragraph audit opinion are highlighted in bold.**

#### REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Board of Directors  
U.S. Technologies Inc.  
Washington, D.C.

We have audited the accompanying consolidated balance sheets of U.S. Technologies Inc. as of December 31, 2001 and 2000 and the related consolidated statements of operations, stockholders' equity (capital deficit), and cash flows for each of the two years in the period ended December 31, 2001. These financial statements are the responsibility of the Company's management. 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 and schedule are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements and schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements and schedule. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of U.S. Technologies Inc. at December 31, 2001 and 2000, and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2001 in conformity with accounting principles generally accepted in the United States of America.

**The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the consolidated financial statements, the Company has suffered recurring losses from operations and has a working capital and net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 2. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.**

/s/ Radin, Glass & Co., LLP  
Certified Public Accountants  
New York, NY  
April 10, 2002

#### What does the report mean for financial statement users?

This report contains the standard three paragraphs included in an unqualified opinion. The second paragraph is a standard paragraph that indicates the audit firm conducted its audit in accordance with generally accepted auditing standards (*this would now read in accordance with the standards of the Public Companies Accounting Oversight Board*) and there were no limitations to the scope of the auditor's work. In the third paragraph the auditor expresses an unqualified opinion, which concludes that the financial statements present fairly U.S. Technologies' financial position, results of operations and cash flows.

The final paragraph (in bold) indicates that the auditor reached a conclusion that there is "substantial doubt" about U.S. Technologies' ability to continue as a going concern, due to the company's recurring losses, its working capital deficiency, and net capital deficiency. In addition, the auditor points out that no adjustments have been made to the financial statements as a result of this uncertainty, such as classifying all assets and liabilities as current or valuing assets at liquidation value.

#### What are the auditor's criteria for using this type of report?

Professional standards require that auditors evaluate the entity's ability to continue as a going concern in every audit. The auditor's responsibility is to determine whether there is *substantial doubt* (not just doubt) about whether the entity can continue as a going concern for a period of one year from the date of the financial statements. The auditor evaluates whether there is substantial doubt about the entity's ability to continue as a going concern based on the results of normal audit procedures (risk assessment procedures and further audit procedures) performed to form an opinion on the financial statements. If the auditor believes there is substantial doubt about the entity's ability to continue as a going concern, he or she should take the following steps: (1) obtain information about management's plans that are intended to mitigate the effect of such conditions or events, and (2) assess the likelihood that such plans can be effectively implemented. This is discussed further in Chapter 19.

If the auditor determines that substantial doubt exists, the auditor will evaluate the adequacy of management's disclosure. If there is adequate disclosure, then the auditor will add a fourth paragraph expressing the firm's conclusion about going concern. If the auditor concludes that disclosure is inadequate, the auditor will issue a qualified opinion or an adverse opinion associated with a departure from GAAP.

**Unqualified Opinion on the Financial Statements with Explanatory Language regarding a change in accounting principles accounted for in conformity with GAAP:** The following opinion was issued by Ernst and Young, LLP on January 29, 2003 with respect to the financial statements for Verizon Communications, Inc. for the years ended December 31, 2002, 2001, and 2000. **Note: The portions of the auditor's report that differ from the standard, three-paragraph audit opinion are highlighted in bold.**

#### REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Shareowners of Verizon Communications Inc.:

We have audited the consolidated balance sheets of Verizon Communications Inc. and subsidiaries (Verizon) as of December 31, 2002 and 2001, and the related consolidated statements of income, cash flow and changes in shareowners' investment for each of the three years in the period ended December 31, 2002. These financial statements are the responsibility of Verizon's management. 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. 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.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Verizon at December 31, 2002 and 2001 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2002 in conformity with accounting principles generally accepted in the United States.

**As discussed in Note 2 to the consolidated financial statements, Verizon changed its method of accounting for goodwill and other intangible assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 142 "Goodwill and Other Intangible Assets" effective January 1, 2002, and as discussed in Note 14 to the consolidated financial statements, Verizon changed its method of accounting for derivative instruments in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" and SFAS No. 138, "Accounting for Certain for Derivative Instruments and Certain Hedging Activities" effective January 1, 2001.**

/s/ Ernst and Young LLP  
 Certified Public Accountants  
 [New York, NY]  
 January 29, 2003

#### What does the report mean for financial statement users?

This report contains the standard three paragraphs included in an unqualified opinion and then an explanatory paragraph after the opinion.

The second paragraph is a standard paragraph that indicates that the auditor conducted its audit in accordance with generally accepted auditing standards (*this would now read in accordance with the standards of the Public Companies Accounting Oversight Board*) and there were no limitations to the scope of the auditor's work. In the third paragraph the auditor expressed an unqualified opinion, which concludes that the financial statements present fairly Verizon's financial position, results of operations and cash flows.

The fourth paragraph describes the changes in accounting principles (the method of accounting for goodwill and other intangible assets and the method of accounting for derivative instruments) and refers to the notes (2 and 14) to the financial statements where GAAP disclosures regarding the accounting changes are explained.

#### What are the auditor's criteria for using this type of report?

Professional standards state that the consistency of financial statements is key to reporting. A change in accounting principle is made in conformity with GAAP when (1) the new principle is a generally accepted accounting principle, (2) the change is properly accounted for and disclosed in the financial statements, and (3) management can justify that the new principle is preferable. When an acceptable change in GAAP has occurred between accounting periods (material to the financial statements), the auditor adds an explanatory paragraph to describe the change and refer readers to the corresponding note to the financial statements where the effect of the accounting change is described.

These changes result in an unqualified opinion since the financial statements reflect a change from one acceptable generally accepted accounting principle to another, the method of change is acceptable, and the auditor determined that management was justified making the changes, which were driven by new pronouncements of the Financial Accounting Standards Board.

If the auditor concludes that disclosure is inadequate, the auditor will issue a qualified opinion or an adverse opinion associated with a departure from GAAP.

Note: If the change in GAAP is immaterial, a standard auditor's report is used.

**Unqualified Opinion on the Financial Statements with Opinion based in part on report of another auditor where there is no scope limitation or nonconformity with GAAP:** The following opinion is a fictitious opinion for a private company based on the guidance provided in generally accepted auditing standards, AU 508.13. **Note: The portions of the auditor's report that differ from the standard, three-paragraph audit opinion are highlighted in bold.**

#### INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of MLJ Company

We have audited the accompanying balance sheets of MLJ Company as of December 31, 20x2 and 20x1, and the related statements of income, stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. **We did not audit the financial statements of XYZ Company, a wholly owned subsidiary, which statements reflect total assets of \$10 Million and \$ 9 Million as of December 31, 20x2 and 20x1, respectively, and total revenues of \$12 Million and \$ 10 Million 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 XYZ Company, 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. 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 **and the report of other auditors** provide a reasonable basis for our opinion.

In our opinion, **based on our audits and the report of other auditors**, the financial statements referred to above present fairly, in all material respects, the financial position of MLJ Company as of December 31, 20x2 and 20x1 and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

/s/ Reedy and Abel, LLP  
 Certified Public Accountants  
 Portland, Oregon  
 February 14, 20x3

#### What does the report mean for financial statement users?

Note that all three paragraphs are altered for this type of report to reflect shared scope. The introductory paragraph mentions another auditor and the principal auditor explains a division of responsibility. This paragraph explains the magnitude of the portion of the financial statements audited by other auditors.

The scope paragraph also mentions that the other auditor's report was an important basis for the principal auditor's opinion.

Finally, the opinion paragraph expresses an unqualified opinion on the financial statements, stating that in the auditors' opinion, they fairly present the entity's financial position, results of operations, and cash flows. The opinion paragraph mentions the work of the other auditor to explain a division of responsibility between the other auditor and the principal auditor regarding the basis for the unqualified opinion.

The name of the other auditor is not mentioned unless that auditor gives express permission to use the name and the report of that auditor is also presented.

#### What are the auditor's criteria for using this type of report?

Auditors use this report when another auditor has performed a material part of the audit examination and the principal auditor decides to explain the division of responsibility. The auditor may mention the other auditor if the work was not well known to the principal auditor such as work performed by a correspondent firm, if the work was not performed under the principal auditor's guidance and/or the principal auditor did not review the work of the other auditor.

Once the principal auditor has decided to mention the other auditor, he is required to make inquiries about the professional reputation and to obtain a representation from the audit firm that it is independent of the entity. In cases where the other firm's principal practice is in a foreign country, the principal auditor should also communicate with the other auditor to ascertain the auditor's familiarity with GAAS and GAAP in the United States.

If no reference is made to another auditor in the auditor's report the principal auditor has assumed responsibility for any work performed by another auditor, and a standard report will be issued.

**Unqualified Opinion on the Financial Statements with Emphasis of a matter by the auditor:** The following opinion is a fictitious opinion for a private company based on the guidance provided in generally accepted auditing standards, AU 508.19. **Note: The portions of the auditor's report that differ from the standard, three-paragraph audit opinion are highlighted in bold.**

#### INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of MLJ Company:

We have audited the accompanying balance sheets of MLJ Company as of December 31, 20x5 and 20x4, and the related statements of income, stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. 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. 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of MLJ Company as of December 31, 20x5 and 20x4 and the results of its operations and its cash flows for each of the years then ended in conformity with accounting principles generally accepted in the United States.

**As discussed in note 8 to the financial statements, the Company has had numerous dealings with businesses controlled by, and people who are related to, the officers of the Company.**

/s/ Reedy and Abel, LLP  
 Certified Public Accountants  
 Portland, Oregon  
 February 14, 20x6

#### What does the report mean for financial statement users?

First, this report contains the standard three paragraphs included in an unqualified opinion. The second paragraph is a standard paragraph that indicates that the auditor conducted their audit in accordance with generally accepted auditing standards (*reports on the audits of public companies would refer to the standards of the PCAOB*) and there were no limitations to the scope of the auditor's work. In the third paragraph the auditor expresses an unqualified opinion, which concludes that the financial statements present fairly MLJ Company's financial position, results of operations and cash flows.

Second, the auditor includes a fourth paragraph to emphasize a matter that the auditor feels warrants some additional explanatory language, while still expressing an unqualified opinion. In this case the auditor wants to point the reader to note 8 that discusses related party transactions.

#### What are the auditor's criteria for using this type of report?

Emphasis paragraphs are not required. The auditor uses this type of report to emphasize a matter to the financial statement user. This is still an unqualified opinion, but the auditor feels that an issue should be emphasized to the financial statement user. Examples of matters the auditor may wish to emphasize are —

The entity is a component of a larger business enterprise.  
 The entity has had significant transactions with related parties.

The entity has unusually important subsequent events.

Phrases such as "with the foregoing [following] explanation" should not be used in the opinion paragraph as it could be misconstrued as a qualification of the auditor's opinion.

**Qualified Opinion for Departure from GAAP:** The following opinion is a fictitious opinion for a private company based on the guidance provided in generally accepted auditing standards, AU 508.35-.57. **Note: The portions of the auditor's report that differ from the standard, three-paragraph audit opinion are highlighted in bold.**

#### INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of MLJ Company

We have audited the balance sheets of MLJ Company as of December 31, 20x7 and 20x6, and the related statements of income, stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. 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. 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.

**The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by \$18 Million and \$16 Million long-term debt by \$19.5 Million and \$18.8 Million, and retained earnings would be decreased by \$1.5 Million and \$2.8 Million as of December 31, 20x7 and 20x6, respectively. Additionally, net income would be decreased by \$1.5 Million and \$1.3 Million respectively, for the years then ended.**

In our opinion, **except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph**, the financial statements referred to above present fairly, in all material respects, the financial position of MLJ Company as of December 31, 20x7 and 20x6 and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

//s/ Reedy and Abel, LLP  
 Certified Public Accountants  
 Portland, Oregon  
 February 14, 20x8

#### What does the report mean for financial statement users?

This report has a standard introductory and scope paragraph meaning that there were no scope restrictions and the auditor was able to perform an audit in accordance with generally accepted auditing standards. When performing the audit, the auditor determined that the financial statements contained a material departure from generally accepted accounting principles that management did not change. The financial statements are the responsibility of management, and in this case, management chose to treat capital leases as operating leases.

In the third paragraph the auditor explains the departures from GAAP in sufficient detail that financial statement users can modify the financial statement before analyzing their content.

The opinion paragraph states that "except for" the failure to treat capital leases in accordance with generally accepted accounting principles, the balance of the financial statements are presented fairly, in all material respects.

The fact that the auditor has the ability to issue this type of report often causes audit entities to make adjustments necessary to present financial statements in accordance with GAAP and earn an unqualified opinion from their auditors.

#### What are the auditor's criteria for using this type of report?

The auditor expresses this type of opinion after making a judgment that the financial statements contain a material departure from generally accepted accounting principles and the effect on the financial statements is material.

The decision about whether to express a qualified or an adverse opinion (see separate example of an adverse opinion) should be based on the materiality of the departure from generally accepted accounting principles, the pervasiveness of the departure from GAAP, and the significance of the items to the financial statements as a whole.

Departure from generally accepted accounting principles might include

- Inadequate disclosures in the notes to the financial statements.
- Inappropriate use of accounting principles.
- Unreasonable accounting estimates.

When it is practicable, the auditor will provide the disclosures, or quantify their effect on the financial statements in a middle paragraph preceding the opinion paragraph.

Note: If the departure from GAAP is not material the auditor may issue a standard report.

**Qualified Opinion for Scope Limitation:** The following opinion is a fictitious opinion for a private company based on the guidance provided in generally accepted auditing standards, AU 508.22-.34. **Note: The portions of the auditor's report that differ from the standard, three-paragraph audit opinion are highlighted in bold.**

#### INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of MLJ Company

We have audited the accompanying balance sheets of MLJ Company as of December 31, 20x8 and 20x7, and the related statements of income, stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

**Except as discussed in the following paragraph,** we conducted our audits in accordance with auditing standards generally accepted in the 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.

**We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at \$10 Million and \$9.5 Million at December 31, 20x8 and 20x7, respectively, or its equity in earnings of that affiliate of \$500,000 and \$ 350,000, which is included in net income for the two years then ended and described in Note 12 to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.**

In our opinion, **except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings,** the financial statements referred to above present fairly, in all material respects, the financial position of MLJ Company as of December 31, 20x8 and 20x7 and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

/s/ Reedy and Abel, LLP  
 Certified Public Accountants  
 Portland, Oregon  
 February 14, 20x9

#### What does the report mean for financial statement users?

Note that the second paragraph refers the reader to a third paragraph that explains why the auditor was not able to fully perform an audit in accordance with generally accepted auditing standards. Other than the one exception noted, the auditor performed an audit in accordance with generally accepted auditing standards.

The explanatory paragraph describes the magnitude of not being able to audit the financial statements of a foreign affiliate, both in terms of the investment reported on the balance sheet and the earnings from the foreign affiliate reported on the income statement. This paragraph states that the auditor has not obtained satisfactory evidence for these items to support an unqualified opinion.

The auditor's qualified opinion tells the user that the auditor was not able to fully complete the audit due to scope limitations. In this example, the user obtains no assurance regarding the investment in the foreign affiliate or earnings of that foreign affiliate. However, other than this one exception, the auditor was able to perform an audit in accordance with generally accepted auditing standards and the auditor issues an unqualified opinion on all other aspects of the financial statements.

#### What are the auditor's criteria for using this type of report?

If a scope limitation exists, the auditor must choose between a qualified opinion and a disclaimer of opinion (see separate example of a disclaimer of opinion). The auditor's decision to qualify his or her opinion or disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on the financial statements being audited. Auditors normally make this judgment by considering the significance of the omitted procedure(s) relative to the financial statements.

For example, the auditor might issue a qualified opinion: When the auditor cannot obtain audited financial statements to support an investment in an affiliated company. When the audit firm is engaged after the beginning of the year and the auditor is unable to observe beginning inventories.

When the entity has inadequate accounting records, such as with an initial audit of fixed assets where assets have been owned for many years.

These are scope limitations imposed by the circumstances of the engagement and they do not have a pervasive effect on the financial statements.

**Adverse Opinion for Departure from GAAP:** The following opinion is a fictitious opinion for a private company based on the guidance provided in generally accepted auditing standards, AU 508.58-.60. **Note: The portions of the auditor's report that differ from the standard, three-paragraph audit opinion are highlighted in bold.**

#### INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of MLJ Company:

We have audited the balance sheets of MLJ Company as of December 31, 20x3 and 20x2, and the related statements of income, stockholders' equity and cash flows for each of the years then ended. These financial statements are the responsibility of the Company's management. 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. 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.

**As discussed in Note 6 to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Generally accepted accounting principles require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided.**

**Because of the departures from generally accepted accounting principles identified above, as of December 31, 20x3 and 20x2, inventories have been increased \$9 Million and \$9 Million by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is carried at \$10 Million and \$12 Million in excess of an amount based on the cost to the Company; and deferred income taxes of \$3 Million and \$4 Million have not been recorded; resulting in an increase of \$12 Million and \$14 Million in retained earnings and in appraisal surplus of \$10 Million and \$12 Million, respectively. For the years ended December 31, 20x3 and 20x2, cost of goods sold has been increased \$1 Million and \$2 Million respectively, because of the effects of the depreciation accounting referred to above and deferred income taxes of \$2 Million and \$3.5 Million have not been provided, resulting in an increase in net income of \$1 Million and \$1.5 Million, respectively.**

**In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States, the financial position of MLJ Company as of December 31, 20x3 and 20x2, or the results of its operations or its cash flows for the years then ended.**

//s/ Reedy and Abel, LLP  
 Certified Public Accountants  
 Portland, Oregon  
 February 14, 20x4

#### What does the report mean for financial statement users?

This report has a standard introductory and scope paragraph, meaning that there were no scope restrictions and the auditor was able to perform an audit in accordance with generally accepted auditing standards. When performing the audit, the auditor determined that the financial statements contained an extreme material departure from generally accepted accounting principles that management did not change. The financial statements are the responsibility of management, and in this case, management chose to value property, plant, and equipment at its fair value, to provide depreciation based on fair value, and to omit the provision for deferred income taxes.

The auditor carefully detailed the departures from generally accepted accounting principles in the middle paragraphs, but the auditor also determined that the departures were so material and so pervasive that the financial statement *did not* fairly present financial position or results of operations, or cash flows in accordance with generally accepted accounting principles.

The fact that the auditor has the ability to issue this type of report often causes audit entities to make adjustments necessary to present financial statements in accordance with GAAP and earn an unqualified opinion from their auditors.

#### What are the auditor's criteria for using this type of report?

The decision to express an adverse opinion rather than a qualified opinion is based on the materiality and the pervasiveness of the departure from generally accepted accounting principles, and the significance of the items to the financial statements as a whole. Auditors normally express this type of opinion on the financial statements when the departure from generally accepted accounting principles is extremely material and pervasive to the financial statements, and the financial statements are so misleading that they do not fairly present financial position, results of operations, or cash flows of the entity.

**Disclaimer of Opinion for Scope Limitation:** The following opinion is a fictitious opinion for a private company based on the guidance provided in generally accepted auditing standards, AU 508.22-.34 and AU 508.61-63. **Note: The portions of the auditor's report that differ from the standard, three-paragraph audit opinion are highlighted in bold.**

#### INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of MLJ Company

We were engaged to audit the balance sheets of MLJ Company as of December 31, 20x4 and 20x3, and the related statements of income, stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. **[Omit last sentence of the introductory paragraph.]**

**[Omit the scope paragraph.]**

**The Company did not make a count of its physical inventory in 20x4 or 20x3, stated in the accompanying financial statements at \$6.5 Million as of December 31, 20x4, and at \$7.1 Million as of December 31, 20x3. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 20x3, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.**

**Since the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.**

/s/ Reedy and Abel, LLP  
 Certified Public Accountants  
 Portland, Oregon  
 February 14, 20x5

#### What does the report mean for financial statement users?

A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. An auditor may decline to express an opinion whenever he or she is unable to form, or has not formed, an opinion as to the fairness of presentation of the financial statements in conformity with generally accepted accounting principles.

There are a number of signals that the auditor has not given an opinion on the financial statements. Note that the introductory paragraph says that the auditor was "engaged to audit" rather than "we have audited." The last sentence that normally states that the auditor's responsibility is to express an opinion on the financial statements is also omitted as the auditor has not formed an opinion on the financial statements.

The scope paragraph is omitted from the report because the scope limitation is so severe that the auditor is unable to comply with generally accepted auditing standards and therefore has not completed the scope of an audit.

The third paragraph provides all of the substantive reasons for the disclaimer and describes the potential effects on the financial statements of the items for which the auditor has not obtained satisfactory evidence to support an unqualified opinion. In the example to the left, the auditor specifies the amount of inventory that was not supported by an inventory observation.

Finally, the opinion paragraph explains that due to the severe scope limitations, the auditor is unable to express an opinion on the financial statements.

#### What are the auditor's criteria for using this type of report?

The auditor's decision to disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on the financial statements being audited.

A disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable him or her to form an opinion on the financial statements. In addition, when the entity imposes significant scope restrictions, the auditor will usually disclaim an opinion on the financial statements. For example, the refusal of management to take responsibility for financial statements or sign a representation letter would normally lead to a disclaimer of opinion. In addition, if management prevented audit procedures that are significant to the financial statements, such as requesting confirmation of the existence and terms of receivables, the auditor should disclaim opinion on the financial statements.

**Unqualified Opinion—Other Comprehensive Basis of Accounting:** The following opinion is a fictitious opinion for a private company based on the guidance provided in generally accepted auditing standards, AU 623.02-.10. **Note: The portions of the auditor's report that differ from the standard, three-paragraph audit opinion are highlighted in bold.**

#### INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of MLJ Company:

We have audited the accompanying **statements of assets, liabilities, and capital—income tax basis of MLJ Partnership as of December 31, 20x6 and 20x5, and the related statements of revenue and expenses—income tax basis and of changes in partners' capital accounts—income tax basis** for the years then ended. These financial statements are the responsibility of the Partnership's management. 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. 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.

**As described in Note 1, these financial statements were prepared on the basis of accounting the Partnership uses for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.**

In our opinion, the financial statements referred to above present fairly, in all material respects, **the assets, liabilities, and capital of MLJ Partnership as of December 31, 20x6 and 20x5, and its revenue and expenses and changes in partners' capital accounts for the years then ended, on the basis of accounting described in Note 1.**

//s/ Reedy and Abel, LLP  
 Certified Public Accountants  
 Portland, Oregon  
 February 14, 20x7

#### What does the report mean for financial statement users?

In some cases private companies will use a comprehensive basis of accounting other than generally accepted accounting principles. For example, many small business prepare financial statements using the same basis of accounting that they use for federal income tax purposes. These companies can engage the auditor to audit the financial statements prepared on an other comprehensive basis of accounting (OCBOA), and many times banks and other creditors will use those financial statements when making credit decisions.

The reader will notice an immediate difference in the introductory paragraph as the financial statement names reflect the basis of accounting. The terms balance sheet, income statement, and statement of cash flows, without modification, are reserved for generally accepted accounting principles.

The scope paragraph is the same as the standard report because the scope of the audit has not been limited.

There is an explanatory paragraph before the opinion, which states the basis of presentation and refers to the note to the financial statement that describes the comprehensive basis of accounting that was used to prepare the financial statements.

The opinion paragraph is slightly modified from the standard report to reflect the different financial statement titles and to state that the financial statements present fairly according to the accounting basis described in the note to the financial statements. If the auditor felt that the financial statements departed materially from the other comprehensive basis of accounting, the auditor would issue a qualified or adverse opinion.

#### What are the auditor's criteria for using this type of report?

The auditor should issue this type of report when the entity uses a basis of accounting other than GAAP. Many companies subject to regulatory bodies keep their books solely according to the method prescribed by the agency. Also, many small businesses and individual practitioners use the tax, cash, or modified cash basis of accounting.

There are four comprehensive bases of accounting other than GAAP that are recognized:

1. A basis used to comply with the requirements of a regulatory agency
2. The basis used to file the entity's income tax return
3. The cash receipts and disbursements basis of accounting
4. A basis that uses a definite set of criteria with substantial support such as the price-level basis of accounting

## objective questions

Objective questions are available for the students at [www.wiley.com/college/boynton](http://www.wiley.com/college/boynton)

## comprehensive questions

2-23 **(Relationship between accounting and comprehensive auditing)** Listed below in alphabetical order are the steps that are included in preparing and completing a comprehensive audit, and distributing financial statements.

1. Analyze events and transactions.
2. Assess the risk of material misstatement in management's financial statements.
3. Classify and summarize recorded data.
4. Communicate findings to management and the board of directors through other required communications and assurance services.
5. Distribute financial statements and auditor's report to stockholders in annual report.
6. Evaluate reasonableness of accounting estimates.
7. Express opinion through auditor's report and other communications.
8. Measure and record transaction data.
9. Perform risk assessment procedures including understanding the business and its internal controls.
10. Prepare financial statements per GAAP.
11. Obtain and evaluate evidence to respond to risks of material misstatement in the financial statements.
12. Obtain reasonable assurance that financial statements are presented fairly in conformity with GAAP.

Required

- a. Prepare a diagram of the relationship between accounting and auditing in the preparation and audit of financial statements. Show each of the steps in the proper sequence.
- b. Management and the independent auditor share the responsibility for the assertions contained in financial statements. Evaluate and discuss the accuracy of this statement.
- c. Public companies hire auditors because of a requirement to comply with the rules of the SEC. Evaluate and discuss the accuracy of this statement.

2-24 **(Financial statement audits)** The following two statements are representative of attitudes and opinions sometimes encountered by CPAs in their professional practices:

1. Today's audit consists of test checking. This is dangerous because test checking depends on the auditor's judgment, which may be defective. An audit can be relied on only if every transaction is verified.
2. An audit by a CPA is essentially negative and contributes to neither the gross national product nor the general well-being of society. The auditor does not create; he merely checks what someone else has done.

Required

Evaluate each of the above statements and indicate

- a. Areas of agreement with the statement, if any.
- b. Areas of misconception, incompleteness, or fallacious reasoning included in the statement, if any.

Complete your discussion of each statement (both parts a and b) before going on to the next statement.

AICPA (adapted)

2-25 **(Management and auditor responsibilities)** Footnotes are important in determining whether the financial statements are presented fairly in accordance with generally accepted accounting principles. Following are two sets of statements concerning footnotes.

1. Student A says that the primary responsibility for the adequacy of disclosure in the financial statements and footnotes rests with the auditor in charge of the audit field work. Student B says that the partner in charge of the engagement has the primary responsibility. Student C says that the staff person who drafts the statements and footnotes has the primary responsibility. Student D contends that it is the entity's responsibility.

Required

Which student is correct?

2. It is important to read the footnotes to financial statements, even though they often are presented in technical language and are incomprehensible. The auditor may reduce his exposure to third-party liability by stating something in the footnotes that contradicts completely what he has presented in the balance sheet or income statement.

Required

Evaluate the above statement and indicate:

- a. Areas of agreement with the statement, if any.
- b. Areas of misconception, incompleteness, or fallacious reasoning included in the statements, if any.

AICPA (adapted)

2-26 **(Generally accepted auditing standards)** There are 10 GAAS. Listed below are statements that relate to these standards.

1. The auditor is careful in doing the audit and writing the audit report.
2. A more experienced auditor supervises the work of an inexperienced auditor.
3. The auditor investigates and reaches conclusions about the entity and its environment including its internal controls.
4. A predesigned schedule is followed during the audit.
5. The auditor is an accounting graduate with several years of experience in auditing.
6. In the auditor's judgment, the financial statements conform to all FASB statements.
7. The auditor is objective and unbiased in performing the audit.
8. The entity used the same accounting principles this year as last year.
9. The audit produced all the evidence needed to reach a conclusion about the entity's financial statements.

10. The entity's notes to the financial statements contain all essential data.
11. The auditor expresses an opinion on the financial statements.

Required

- a. Identify by category and number within each category the GAAS to which each statement relates (i.e., general standard no. 1, field work standard no. 2, etc.).
- b. For each answer in (a) above, provide the full statement of the standard. Use the following format for your answers:

IDENTIFICATION OF STANDARD	STATEMENT OF STANDARD

- 2-27 **(Detection of misstatements including fraud)** Reed, CPA, accepted an engagement to audit the financial statements of Smith Company. Reed's discussions with Smith's new management and the predecessor auditor indicated the possibility that Smith's financial statements may be misstated due to the possible occurrence of errors, fraud, and illegal acts.

Required

- a. Identify and describe Reed's responsibilities to detect Smith's errors and fraud. Do not identify specific audit procedures.
- b. Identify and describe Reed's responsibility to report Smith's errors and fraud.

AICPA (adapted)

- 2-28 **(Illegal client acts)** During the year under audit, an entity may have committed an illegal act.

- a. Define the term *illegal act*.
- b. What characteristics of illegal acts influence the auditor's responsibilities?
- c. The auditor's responsibility for illegal client acts is the same regardless of their effects on the financial statements. Do you agree? Explain.
- d. What information during the course of an audit may be indicative of possible illegal acts? How should the auditor respond to this evidence?
- e. What are the possible effects of illegal acts on the auditor's report? What other responsibilities does the auditor have to communicate illegal acts to others?

- 2-29 **(GAAP vs. GAAS)** The auditor's standard report contains the terms generally accepted auditing standards and generally accepted accounting principles.

Required

- a. Indicate the paragraph(s) of the standard report in which each term appears.
- b. Distinguish between the terms.
- c. Why is it important that the auditor state that the audited financial statements are in conformity with GAAP?
- d. What is the relationship, if any, between Statements on Auditing Standards and GAAS?

2-30 **(Auditor's standard report)** The auditor's standard report contains standardized wording. Listed below are the sentences in the standard report.

1. We conducted our audit in accordance with auditing standards generally accepted in the United States.
2. We believe that our audit provides a reasonable basis for our opinion.
3. In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20x2 and 20x1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.
4. We have audited the accompanying balance sheets of X Company as of December 31, 20x2 and 20x1, and the related statements of income, retained earnings, and cash flows for the years then ended.
5. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.
6. Our responsibility is to express an opinion on these financial statements based on our audits.
7. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
8. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.
9. These financial statements are the responsibility of the company's management.

Required

- a. Identify the paragraph in which each sentence appears. If there is more than one sentence in the paragraph, indicate the sequence of the sentence in the paragraph.
- b. State the primary purpose of each paragraph in the standard report.

2-31 **(Departures from standard report)** Circumstances may necessitate a departure from the auditor's standard report.

Required

- a. Indicate the two types of departures from the auditor's standard report.
- b. Indicate the effects on the auditor's report when a company makes a change in an accounting principle in conformity with GAAP.
- c. State the other types of opinions an auditor may express.
- d. Indicate the effects on the auditor's report when the auditor wishes to express a qualified opinion because of nonconformity with GAAP.

2-32 **(Auditor's standard report on internal control)** The auditor's standard report contains standardized wording. Listed below are the sentences in the standard report.

1. X Company is responsible for its assessment about the effectiveness of internal control over financial reporting.
2. We believe that our audit provides a reasonable basis for our opinion.
3. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.
4. Our responsibility is to express an opinion on management's assessment based on our audit.

5. Our audits included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances.
6. 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.
7. 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 (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.
8. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective control over financial reporting was maintained in all material respects.
9. In our opinion, management's assertion that ABC Corporation and subsidiaries maintained effective internal control over financial reporting as of June 30, 2004, is fairly stated, in all material respects, based on the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).
10. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements.

Required

- a. Identify the paragraph in which each sentence appears. If there is more than one sentence in the paragraph indicate the sequence of the sentence in the paragraph.
- b. State the primary purpose of each paragraph in the standard report.

## cases

- 2-33 **(Generally accepted auditing standards)** Ray, the owner of a small company, asked Holmes, CPA, to conduct an audit of the company's records. Ray told Holmes that an audit is to be completed in time to submit audited financial statements to a bank as part of a loan application. Holmes immediately accepted the engagement and agreed to provide an auditor's report within three weeks. Ray agreed to pay Holmes a fixed fee plus a bonus if the loan was granted.

Holmes hired two accounting students to conduct the audit and spent several hours telling them exactly what to do. Holmes told the students not to spend time reviewing the controls, but instead to concentrate on proving the mathematical accuracy of the ledger accounts and summarizing the data in the accounting records that support Ray's financial statements. The students followed Holmes's instructions and after two weeks gave Holmes the financial statements that did not include footnotes. Holmes reviewed the statements and prepared an unqualified auditor's report. The report, however, did not refer to generally accepted accounting principles or to the year-to-year application of such principles.

Required

Briefly describe each of the generally accepted auditing standards and indicate how the action(s) of Holmes resulted in a failure to comply with each standard. Organize your answer as follows:

BRIEF DESCRIPTION OF GENERALLY ACCEPTED AUDITING STANDARDS	HOLMES'S ACTIONS RESULTING IN FAILURE TO COMPLY WITH GENERALLY ACCEPTED AUDITING STANDARDS

2-34 **(Detection of fraud)** Several years ago, Dale Holden organized Holden Family Restaurants. Holden started with one restaurant that catered to the family trade. Holden's first restaurant became very popular because the quality of the food and service was excellent, the restaurant was attractive yet modest, and the prices were reasonable.

The success with his first restaurant encouraged Dale Holden to expand by opening additional Holden Family Restaurants in other metropolitan locations throughout the state. Holden has opened at least one new restaurant each year for the last five years, and there are now a total of eight restaurants. All of the restaurants are successful because Holden has been able to maintain the same high standards that were achieved with the original restaurant.

With the rapid expansion of business, Holden has hired a controller and supporting staff. The financial operations of the restaurants are managed by the controller and his department. This allows Holden to focus his attention on the restaurant operations and plan for future locations.

Holden has applied to the bank for additional financing to open another restaurant this year. For the first time ever, the bank asked him to provide financial statements audited by a CPA. The bank assured Holden that the certified statements were not being required because it doubted his integrity or thought him to be a poor credit risk. The loan officer explained that bank policy required all businesses over a certain size to supply audited statements with loan applications, and Holden's business had reached that size.

Holden was not surprised by the bank's requirement. He had ruled out an audit previously because he has great respect for his controller's ability, and he wanted to avoid the fee associated with the first audit as long as possible. However, the growth of his business and the increased number of restaurant locations make an audit a sound business requirement. He also believes that an additional benefit of the independent audit will be the probable detection of any fraud that may be occurring at his restaurants.

To fulfill the bank request for audited statements, Dale Holden has hired Hill & Associates, CPAs.

Required

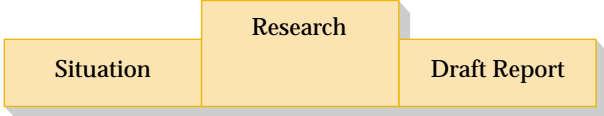
- a. Hill & Associates has been hired to perform an audit leading to the expression of an opinion on Holden Family Restaurants' financial statements. Discuss Hill & Associates' responsibility for the detection of fraud in a general-purpose audit.
- b. What effect, if any, would the detection of fraud during the audit of Holden Family Restaurants by Hill & Associates have on their expression of an opinion on the financial statements? Give the reasons for your answer.

CMA (adapted)

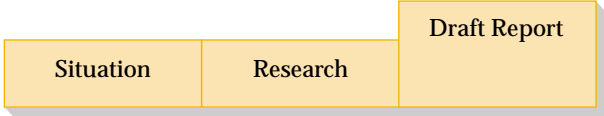
professional simulation



You are working on the ToyCo audit for the year ended December 31, 20X2. Assume that each of the two sections of this question are unrelated.



During the year ended December 31, 20X2 ToyCo acquired a 30% investment in an unconsolidated foreign subsidiary, ForCo that sells raw materials to the company and others. As of February 2, 20X3 management had received only unaudited financial statements from ForCo, which it used to book its investment and the equity in the earnings of the foreign affiliate. The unaudited financial statements are the only information that you can obtain regarding the material investment in ForCo. The partner in charge of the engagement has reached a conclusion that it is likely that no additional evidence will be available to support the investment in ForCo and she would like to know the potential impact on the audit report. Research the issue of the potential lack of evidence about ForCo on the auditor’s report. Cut and paste the standard sections that apply to this issue.



Your audit firm was first engaged to audit ToyCo on April 1, 20X0. The company’s first audit was for the year ended December 31, 20X0. Your firm was unable to audit inventories on January 1, 20X0. You are now completing the audit of comparative balance sheets as of December 31, 20X2 and 20X1, and related statements of income, retained earnings, and cash flows for the years then ended. Draft the auditor report on the comparative financial statements for the two years ended December 31, 20X2.