1988

New Auditor's Report : What it Means to You

American Institute of Certified Public Accountants (AICPA)

The New Auditor's Report

What it means to you

THE PURPOSE OF AN AUDIT

An audit *adds credibility to management's representations* in financial statements.

AUDITOR INDEPENDENCE

Independence is the cornerstone of the auditing profession. It means that the auditor is unrelated to 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.

ASSURANCE PROVIDED BY AN AUDIT

The independent Certified Public Accountant (CPA) tests the data underlying financial position, results of operations, and cash flows to form an opinion on the fairness of the presentation of the financial statements in accordance with generally accepted accounting principles. The auditor's standard opinion provides *reasonable assurance* that the financial statements are free of material misstatements.

THE STANDARD AUDITOR'S REPORT IS NOT A "CLEAN BILL OF HEALTH"

Many financial statement users consider an auditor's standard report to be 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 control structure. The auditor's opinion on the financial statements does not report on these matters.

An audit does provide users with reasonable assurance that an entity's financial statements present fairly, in all material respects, its financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. An audit enhances users' confidence that financial statements do not contain material misstatements because the auditor is an independent, objective expert who is knowledgeable of the entity's business and financial reporting requirements.

AN EXAMPLE AUDITOR'S REPORT

An example of the auditor's standard report, and an explanation of its wording, is provided on the inside panels.

WHAT DOES REASONABLE ASSURANCE MEAN?

Auditor Responsibility for Detecting Material Misstatements. *The independent audit provides reasonable assurance that the financial statements are free of material misstatement.* The following characteristics of an audit are important to understanding the difference between reasonable assurance and a guarantee, or absolute assurance.

Audits Involve Tests. An auditor does not examine 100 percent of the information supporting financial statements. The auditor exercises skill and judgment in deciding what evidence to look at, when to look at it, and how much to look at to determine the fairness of the financial statements.

Auditing Accounting Estimates. Many significant presentations in financial statements involve management estimates (e.g., the amount of uncollectable receivables or a warranty liability). An auditor designs tests to evaluate the reasonableness of management's assumptions and other factors that influence the accounting estimates. Because estimates are inherently imprecise, the auditor's involvement does not assure their precision, just their reasonableness.

Detection of Fraud. An audit is planned and performed with an attitude of professional skepticism; that is, the auditor assesses the risk of material misstatement and designs the audit to provide reasonable assurance of detecting significant errors or fraud. However, irregularities or frauds that are concealed through forgery or collusion (among client personnel or outsiders) result in misleading information. An auditor is not trained to detect forgeries, nor will customary audit procedures detect all conspiracies.

Therefore, audits provide an economical and reasonable level of assurance that the financial statements are free of material misstatements, rather than a guarantee of accuracy.

For more information about auditor's reports, a booklet entitled *Understanding Audits and the Auditor's Report—A Guide for Financial Statement Users* can be obtained from the American Institute of Certified Public Accountants.

AICPA
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A SAMPLE STANDARD AUDITOR'S REPORT

Independent Auditor's Report

To Sample Company, The Board of Directors, and Shareholders:

(Introductory Paragraph)

We have audited the accompanying balance sheets of Sample Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, 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.

(Scope Paragraph)

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

(Opinion Paragraph)

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Sample Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

R. Johnson & Co.
Certified Public Accountants

February 14, 19X3

THE AUDITOR'S STANDARD REPORT

The title *"Independent Auditor's Report"* informs financial statement users that the auditor's opinion is from an unbiased CPA.

(Introductory Paragraph)

The financial statements that were audited, management's responsibility for the financial statements, and the auditor's responsibility to provide an opinion on the financial statements, are described by the following phrases in the introductory paragraph:

"We have audited . . ." This phrase states that the financial statements have been audited, which provides the highest level of assurance that can be provided by CPAs.

"the accompanying balance sheets of Sample Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended." The auditor's report covers *only* those financial statements specifically identified in the auditor's report. The CPA has not audited additional information that may also be presented with financial statements.

"These financial statements are the responsibility of the Company's management." The auditor does not develop the information that is the basis for financial statements. Management is responsible for the financial statements.

"Our responsibility is to express an opinion on these financial statements based on our audits." The CPA's representations are contained in the auditor's report. The independent auditor evaluates the evidence underlying management's financial statements, and based upon this work expresses an opinion on the statements. This process adds credibility to *management's* financial statements.

(Scope Paragraph)

The auditor's basis for forming an opinion on the financial statements is described by the following phrases in the scope paragraph.

"We conducted our audits in accordance with generally accepted auditing standards." In this sentence, the auditor states that he or she has complied with the standards established by the auditing profession.

"reasonable assurance" and *"material misstatements . . ."* *The auditor's objective is to provide reasonable assurance,* not a guarantee, *that the financial statements are free of material misstatement.* Misstatements are considered material if they are significant enough to make a difference in the decisions of a reasonable financial statement user.

"examining on a test basis . . ." It is not economical to examine 100% of the financial statement support. The auditor uses professional judgment in conjunction with knowledge of the specific circumstances of the entity to determine what, when, and how much to "test."

"An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation." The auditor is trained in understanding accounting principles and the situations when their application is appropriate. The auditor is also skilled in the evaluation of accounting estimates and the overall presentation of financial statements. These evaluations are a significant aspect of the audit.

"We believe that our audits provide a reasonable basis for our opinion." In this sentence the auditor states that he or she believes that the results of audit tests were sufficient to form an opinion on the financial statements taken as a whole.

(Opinion Paragraph)

The auditor's conclusions as a result of the audit are described by the following phrases in the opinion paragraph.

"In our opinion . . ." This implies that the auditor is "reasonably sure" of his or her conclusions. Like a physician, an auditor's opinion is based on professional judgment, not absolute certainty.

"present fairly" and *"in conformity with generally accepted accounting principles . . ."* The phrase "present fairly" must always be coupled with "in conformity with generally accepted accounting principles" in the auditor's report. The two phrases are linked to form a single concept of fair presentation.

"in all material respects . . ." The phrase reemphasizes materiality. Financial statements cannot be accurate in an absolute sense—they can only be reasonably accurate.

NONSTANDARD AUDITOR'S REPORTS

Following is a brief discussion of some of the more common circumstances in which the auditor might use nonstandard wording in the auditor's report.

Nonstandard Wording in the Introductory Paragraph. Departures from the standard wording will explain when the auditor is sharing responsibility for the audit with other auditors.

Nonstandard Wording in the Scope Paragraph. Departures from standard wording will indicate that the facts and circumstances of the audit prevented the auditor from reaching an opinion on the financial statements taken as a whole.

Nonstandard Wording in the Opinion Paragraph. Departures from the standard wording occur when:

Qualified ("except for") opinions. There is a material restriction on the scope of the auditor's work, or a material departure from generally accepted accounting principles.

Disclaimer of opinion. Scope restrictions are so pervasive that the auditor cannot form an opinion.

Adverse opinion. The auditor concludes that departures from generally accepted accounting principles are so material that the financial statements do not fairly present the entity's financial position, results of operations, and cash flows.

Reports with Explanatory Wording. The auditor may give a *standard opinion* (not a standard report) on the fair presentation of financial statements and still add wording to highlight material changes in accounting principles or in the method of their application, material uncertainties, going concern problems, or other matters the CPA wishes to emphasize.

Reporting Material Misstatements. If material errors or fraud are discovered in the audit, the auditor will bring them to the attention of management (including an audit committee, the board of directors, or a board of trustees), and will issue a qualified or adverse opinion if the financial statements are not appropriately revised.