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Understanding audits and the auditor's report: a guide for financial statement users

American Institute of Certified Public Accountants

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To Sample Company, This is to certify that we have performed the audit of the financial statements for the years ended December 31, 19X2 and 19X1, in accordance with generally accepted auditing standards. Our audit was designed to provide reasonable assurance that the financial statements are free of material misstatement, and that the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles.

We believe that 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.

M. Johnson & Co.
Certified Public Accountants

February 14, 19X3
NOTICE TO READERS

The major objective of this publication is to explain the meaning of the auditor's report and the assurance provided by an auditor's opinion on financial statements. It is intended for users of financial statements who want to better understand the message and significance of audit reports.

This publication supersedes A User's Guide to Understanding Audits and Auditor's Reports, published by the AICPA in 1982. It has not been approved, disapproved, or otherwise acted on by the Auditing Standards Board, the membership, or the governing body of the American Institute of Certified Public Accountants. Therefore, the contents of this publication are not official pronouncements of the Institute.

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November 1988
Understanding Audits and the Auditor's Report

A Guide for Financial Statement Users

American Institute of Certified Public Accountants
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Preface

This publication has been prepared to assist financial statement users in understanding the assurance that an audit provides and the meaning of the specific language used in an auditor's report—the communication from the auditor to financial statement users.

In February 1988, the Auditing Standards Board revised the standard auditor's report to provide clearer descriptions of the auditor's responsibility, the work the auditor does, and the assurance the auditor gives.

This publication helps users understand—

- Management's responsibility for the financial statements and the judgments involved in preparing financial statements in accordance with generally accepted accounting principles.
- The auditor's responsibility for expressing an opinion on management's financial statements and the assurance that is provided by this opinion.
- Some important factors that should be considered in using financial statements.

Chapters 1 through 4 discuss the roles of the parties involved in the preparation, audit, and use of financial statements.

This publication also explains the wording of the standard auditor's report and provides many examples of other auditor's reports that financial statement users may encounter. Chapters 5 and 6 provide examples of the auditor's report, describe when they are used by the auditor, and explain the important elements in these reports. The examples provide a useful reference source for financial statement users who want to understand what audit reports mean.

This publication was written by Raymond N. Johnson, Academic Fellow, of the AICPA Auditing Standards Division. It supersedes A User's Guide to Understanding Audits and Auditors' Reports, published by the AICPA in 1982. Many of the discussions and explanations from the user's guide were useful in developing this publication.
Chapter 1

Introduction to Audits and Financial Reporting

In today's economy, entities have become more dependent on each other, and information and accountability have assumed a larger role in our society. As a result, the Certified Public Accountant's (CPA's) independent audit of an entity's financial statements is a vital service to investors, creditors, and other participants in economic exchanges.

The CPA communicates audit results in a formalized, three-paragraph report. The auditor's report is based on rigorous work performed by highly trained professionals. This booklet explains the financial statement audit, the assurance provided by the independent auditor's report, and the meaning of the report wording.

Need for Financial Statements

Although there are many diverse types of organizations with diverse objectives—some profit-oriented, others charitable or governmental, oriented to serving social needs—all organizations use economic resources to pursue their goals. Financial statements enable an entity's management to provide useful information about its financial position at a particular point in time and the results of its operations and its cash flows for a particular period of time. External financial reporting for these entities is directed toward the common interest of various potential users. Financial statements are a basis for investors' decisions about whether to buy or sell securities, for credit rating services decisions about credit worthiness of entities, for bankers' decisions about whether to lend money, and for other decisions of creditors, regulators, and others outside of the entity.
The Financial Statement Audit

The objective of the financial statement audit is to add credibility to management's representations in financial statements. Access to capital markets, mergers, acquisitions, and investments in an entity depend not only on the information that management provides in financial statements, but also on the degree of assurance that the financial statements are free of material misstatements. In the process of providing reasonable assurance—within the context of materiality—that financial statements conform to generally accepted accounting principles (GAAP), an auditor will assess whether—

- All transactions and accounts that should have been recorded are reported in the financial statements.
- The assets and liabilities reported in the financial statements existed at the balance sheet date, and the transactions reported in the financial statements occurred during the period covered by the statements.
- All reported assets are owned by the entity, and the liabilities are owned by the entity at the balance sheet date.
- The financial statement elements (assets, liabilities, revenues, expenses, cash flows, and so on) are appropriately valued in accordance with GAAP.
- Financial statement elements are properly classified, described, and disclosed in conformity with GAAP.

The independent auditor forms an opinion on the overall fairness, in conformity with GAAP, of the financial statements by testing these economic assertions. The opinion is communicated in the auditor's report. The report can notify financial statement readers about material departures from GAAP, uncertainties that might affect the financial statements, changes in accounting principles, or a variety of other matters. The intended result of financial statements accompanied by an auditor's report is to provide information that is reliable and useful to bankers, investors, and others.

Responsibility for Financial Statements

Effective use of financial statements requires that the reader understand the roles of those responsible for preparing, auditing, and using financial statements. Figure 1 depicts the independent CPA's role in auditing management's financial statements.

Management's Responsibility for Financial Statements

Management is responsible for the content of its financial statements, regardless of an organization's size or form of ownership. The preparation of these statements requires management to make significant judgments and estimates. Management's responsibility for financial statements is not lessened by having the statements audited.
The Independent Audit and the Auditor's Report

An audit allows creditors, bankers, investors, and others to use financial statements with confidence. While the audit does not guarantee financial statement accuracy, it provides 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 GAAP. 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.

FIGURE 1
Relationships in Financial Reporting

Using Financial Statements

The auditor's report and financial statements presented by management are useful only to those who make the effort to understand them. An auditor's report explains the work of the auditor and adds credibility to management's presentations in financial statements. Knowledgeable use of auditor's reports requires a general understanding of both the audit process and the meaning of the auditor's report. Effective use of audited financial statements also requires a basic understanding of GAAP and the related concepts of financial measurement and disclosure. Users should also consider the inherent limitations of financial statements caused by the use of accounting estimates, judgments, and various alternative accounting principles and methods.
Preparing Financial Statements

Management’s Responsibility for Financial Statements

Management is responsible for establishing an accounting system to identify, measure, record, and adequately disclose an entity’s transactions and other events that affect its financial position and operations. In addition, management is responsible for selecting accounting principles appropriate to the events, and for making assessments that affect the accounting process. This responsibility is not lessened by an independent audit. This chapter explains the judgments involved in preparing financial statements in accordance with GAAP.

Objective and Judgmental Issues in the Accounting Process

Some transactions, such as the purchase of inventory, can be objectively identified, measured, and recorded when they occur. While the initial recording of a transaction is often clear, evaluating the subsequent effects of these transactions on financial position, results of operations, or cash flows may require more qualitative judgment. For example, management must estimate the amount of inventory that is either obsolete or the market value of which is significantly impaired. These applications of GAAP require significant assumptions, estimates, and professional judgments that are inherently imprecise.

Effects of Accounting Judgments

The judgments management makes on accounting matters affect financial statements in several ways, as discussed below.
Monetary Measurement

Financial measurement involves measuring the dollar amounts of the effects of events and transactions. Such measurement is not always as easy as determining the amount of a check. Many financial statement amounts involve significant accounting estimates. For example, what portion of credit sales will be uncollectable? How long will depreciable assets remain in use? What product warranty claims will occur? What is a company's liability for deferred income taxes?

Selection of Accounting Principles and Methods

Financial statement preparation can involve choices from among equally acceptable alternative accounting principles and methods, such as selecting an inventory valuation principle or a depreciation method. Different methods may yield diverse financial statement results, and management is responsible for selecting the accounting principles and methods that are appropriate for the circumstances to which they are applied.

Adequacy of Disclosure

Adequacy of disclosure relates to whether information in the financial statements, including the related notes, clearly explains matters that may affect their use and reader understanding. Management's decisions made about disclosures concern both the amount and the usefulness of information in financial statements. A balance should be achieved between detail and summary. Too much disclosure can distract and overburden the user; too little can withhold essential information.

For example, an entity's ability to continue as a going concern is assumed in the preparation of financial statements in the absence of significant information to the contrary. Since experience indicates that continuing operations is highly probable for most entities (although continuation cannot be known for certain), the assumption that an entity is a going concern is not discussed in every financial statement. If there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period (up to one year from the date of the financial statements), then management should disclose, in the notes to the financial statements, pertinent conditions giving rise to the assessment of substantial doubt, the possible effects of such conditions, and other information about the uncertainty.

Generally Accepted Accounting Principles

If management is to fulfill its responsibility for preparing useful financial statements, it must pay careful attention to the quality of its accounting judgments. Financial statement preparers are guided by accounting standards on financial measurement and disclosure. Conventions, rules, and procedures have evolved that serve as guides to
those who are responsible for preparing financial statements. These technical standards and procedures, referred to as **generally accepted accounting principles** (GAAP), provide standards by which an auditor judges financial statements.

Financial statements are considered to conform with GAAP when—

- The accounting principles used by management have general acceptance.
- The accounting principles used by management are appropriate in the circumstances.
- The financial statements contain adequate disclosure.
- The financial statements present the substance of events and transactions within an acceptable range of tolerable error (materiality).

**General Acceptance**

Accounting principles are pragmatic standards that have been developed through (a) deliberations and consensus of authoritative professional bodies or (b) practical decisions about presenting useful financial information. These principles continue to evolve as a result of experience and research, and in response to changes in economic activities and changing user needs.

**Appropriate Accounting Principles**

Generally accepted accounting principles require reporting of the substance of transactions. In certain circumstances, GAAP may permit alternative accounting treatments of the same transaction or event. For example, there are many acceptable methods for valuing inventory or depreciating fixed assets. Unless an official standard exists, management often has latitude, guided by specific circumstances of economic events or transactions, to choose between two or more alternative principles.

**Adequate Disclosure**

Conformity with GAAP requires the disclosure of enough information to enable an informed reader to understand and interpret the financial statements. The disclosures may be made by parenthetical notation or classification in the body of the financial statements or by notes to the statements. Notes are considered an integral part of the financial statements.

**Materiality in the Financial Statements**

Although financial statements contain approximations, they must reflect a reasonable degree of precision. If the degree of misstatement is significant enough to influence or make a difference in the judgment or consequent activities of financial statement users, it is considered **material**.
Materiality is a relative concept. For example, a $5,000 misstatement of sales revenue for a company with a $20,000 net income may be material, while that same misstatement for a company with a $500,000 net income may be immaterial. In addition, qualitative characteristics influence materiality. For example, an error in the financial statements might be small as a percentage of an account balance. This small error, however, may be considered material because it could cause an entity to breach a loan covenant, which could result in a misclassification of current and noncurrent debt.
Chapter 3

Auditing Financial Statements

Assurance and Financial Statements

The purpose of an audit is to provide reasonable assurance that the financial statements present fairly, in all material respects, the entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

Standards established by the American Institute of CPAs allow an entity to choose from three levels of service when it engages a CPA: an audit, a review, and a compilation. Each level of service offers a different degree of assurance, as depicted in figure 2, regarding financial statement presentation and disclosures.

FIGURE 2
Levels of Assurance
Financial Statement Audits

An audit provides the highest degree of assurance for users. The independent CPA tests the data underlying the entity’s financial statements to form an opinion on the fairness of the presentation in financial statements in accordance with GAAP. Such evidence enables the auditor to provide reasonable assurance about whether the financial statements are free of material error or fraud (that is, irregularities).

Financial Statement Reviews

A review is substantially less in scope than an audit, and provides a significantly lower level of assurance than an audit. During a review, the CPA makes inquiries of entity personnel, and performs analytical procedures that enable the CPA to express limited assurance that he or she is not aware of any material changes that should be made to the financial statements to be in conformity with GAAP.

Financial Statement Compilations

A compilation provides no assurance to financial statement users. The CPA merely presents, in the form of financial statements, information that is the representation of management. Ordinarily, the CPA is not obliged to make inquiries or perform procedures to verify, corroborate, or review the information supplied by the client. Therefore, the CPA gives no assurance on the conformity of the financial statements with GAAP.

This booklet explains what an audit is and discusses the meaning of common auditor’s reports. Examples of the standard review and compilation reports for financial statements are presented in appendix A.

Assurance Provided by an Audit

An Auditor Is Independent

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 is the auditor’s client, 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 encourages third parties to confidently use the financial statements covered by the independent auditor’s report.

Auditor Responsibility for Detecting Material Misstatements

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 *insure* or *guarantee* the accuracy of the financial statements. The following characteristics of an audit are important to understanding the difference between *reasonable assurance* and a *guarantee or absolute assurance*.

**Elements of an Audit**

**Audits Involve Tests**

Auditors rarely examine 100 percent of the items in an account or transaction 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, and how much to look at, as well as in interpreting and evaluating test 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.

**Auditing Transactions Versus Accounting Estimates**

When an entity engages in transactions with an outside party, documentary evidence of the transaction is usually created. This evidence provides a substantial basis for the auditor to form an opinion about whether the transaction has been accounted for in accordance with GAAP.

Evidence supporting the fairness of accounting estimates is not as readily available as the evidence supporting transactions. While the auditor will design tests to evaluate the reasonableness of management's assumptions and factors that may influence the accounting estimate, the realization of accounting estimates is frequently related to future events. The evidence supporting the collectability of receivables or loans, the market values of inventory, or the adequacy of warranty liability is inherently inexact and dependent on economic and market conditions. However, economic factors change quickly. Because estimates are inherently imprecise, the auditor's involvement simply assures their reasonableness, and not exactness.

**Detection of Fraud**

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

As a result, a properly designed and executed audit may not detect every material fraud. Therefore, audits can only provide reasonable assurance that financial statements are free of material misstatements and cannot guarantee the accuracy of financial statements.
**Auditor Consideration of Going Concern**

Financial reporting assumes that an entity is a going concern in the absence of significant information to the contrary. In the course of planning and performing an audit, the auditor considers whether conditions and events have been identified that, when considered in the aggregate, raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time (one year from the date of the financial statements). When customary audit procedures raise such substantial doubt, the auditor will obtain information about management's plans to deal with the problem. If, after considering management's plans and their reasonableness, the independent CPA concludes that substantial doubt exists, the auditor considers the adequacy of financial statement disclosure about the uncertainty and includes an additional explanatory paragraph in the auditor's report discussing the conclusion of uncertainty (see page 26).

The auditor has a responsibility to consider the ability of the entity to continue as a going concern for a reasonable period of time, based on its current condition. However, the auditor is not responsible for predicting future conditions or events. For example, the auditor is not expected to predict a significant drop in commodity prices or other changes in the market for a client's products. 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.

**Reporting Material Misstatements**

If material misstatements are discovered in the audit, the auditor brings such items to the attention of management (including the audit committee, the board of directors, or a board of trustees), and will issue a nonstandard audit opinion if the financial statements are not appropriately revised. See pages 32 and 33 for examples of such reports.

**Is the Standard Auditor's Report a Clean Bill of Health?**

Some 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. This is not the objective of a financial statement audit. The auditor's opinion on the financial statements does not pertain to these matters. 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.

An audit 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.
Using Financial Statements

An audit provides users with reasonable assurance that the financial statements, within the tolerance of materiality, present a fair representation of an entity's financial position, results of operations, and cash flows in conformity with GAAP. Financial statement users must, however, consider more than just the auditor's report. They must also evaluate the financial statements in the context of their specific needs.

In making that evaluation, users should—

- **Read the auditor's report.** The auditor's report provides information about the scope of the independent CPA's work and any material concerns that the auditor had about the fairness of presentation of the financial statements in accordance with GAAP. (Chapters 5 and 6 explain the form of the standard auditor's report and certain nonstandard auditor's reports.)

- **Understand the accounting principles used.** The accounting principles that management select may affect the information relevant to the user's decision. An evaluation of the financial statements requires that the user read the notes to the financial statements to ascertain the significant accounting principles used to prepare the statements.

- **Evaluate the financial quality of the entity.** The evaluation of an entity's financial quality—its financial position, operating results, and cash flows—is the user's responsibility. Financial statements provide information that is helpful in making that evaluation. It is the reader's responsibility to interpret these statements according to his or her own interests and concerns.
• **Evaluate business risk, management, and management decisions.** Financial statement users are responsible for deciding whether management has made appropriate decisions. Management will take various business risks with varying degrees of profit potential and uncertainty of results. An audit does not evaluate management's decisions or whether an entity is a safe or profitable business risk. The user must evaluate the quality of past performance and decide whether management has adequate knowledge and experience to successfully guide the entity.

• **Evaluate the risk of doing business with an entity.** Specific decisions about doing business with an entity, such as investing or extending credit, are the responsibility of those contemplating such matters. An audit only adds credibility to management's financial statements that users may consider in evaluating those risks for themselves.
Chapter 5


The most common type of auditor's report is the standard report, also known as an unqualified or clean opinion. This opinion is used when no significant limitations affect the performance of the audit and when the evidence obtained in the audit discloses no material deficiencies in the financial statements or unusual circumstances that affect the auditor's report.

This report is considered a standard report because it consists of three paragraphs containing standard words and phrases having a specific meaning. The first paragraph identifies the financial statements that were audited and describes management’s responsibility for the financial statements and the auditor’s responsibility to provide an opinion on the financial statements. The second paragraph describes the key elements of an audit that provide the basis for forming an opinion on the financial statements. The auditor states explicitly that the audit provided a reasonable basis for an opinion to be formed on the financial statements. In the third paragraph, the auditor communicates his or her opinion. The independent CPA expresses an informed and expert opinion on the financial statements.

Following is an example of the standard auditor's report.
Independent Auditor's Report

To MLJ Company and its Board of Directors:

[Introductory Paragraph]
We have audited the accompanying balance sheets of MLJ 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 MLJ 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.

D. LaRusso & Co.
Certified Public Accountants

February 14, 19X3

The following discussion explains the specific meaning of this standard report.

Report Title

Independent Auditor's Report

The title Independent Auditor's Report informs financial statement users that the auditor's report is from an unbiased CPA. It also distinguishes the report from those of others, such as reports by an audit committee.

Report Address

To MLJ Company and its Board of Directors:

The report may be addressed to the entity whose financial statements are being audited or to its board of directors or stockholders. A report on the financial statements of an unincorporated entity will be
addressed as circumstances dictate; for example, to the partners, to the
genral partner, or to the proprietor. Occasionally, an auditor is retained
to audit the financial statements of an entity that is not the CPA's
client. In such a case, the report is customarily addressed to the client
and not to the directors or stockholders of the entity whose financial
statements are being audited.

Introductory Paragraph

We have audited the accompanying balance sheets of MLJ 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 finan-
cial statements are the responsibility of the Company's management.
Our responsibility is to express an opinion on these financial statements
based on our audits.

The financial statements that were audited, management's responsi-
bility 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 identifies the level of assurance
  the independent CPA is providing and the corresponding responsi-
bility assumed. This is the highest level of assurance that CPAs
  can provide.

- "the accompanying balance sheets of MLJ 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 the financial state-
  ments identified in the report and the related note disclosure. 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." Management, not the auditor, devel-
  ops the information that is the basis for the financial statements. A
  small business that has no employee to maintain accounting records
  or draft financial statements may rely on the CPA for this purpose.
  Nevertheless, management must be sufficiently knowledgeable of
  the enterprise's activities and financial condition as well as applicable
  accounting principles to take responsibility for critical judgments
  embodied in the financial statements. The financial statements are
  the representations of management.

- "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 independ-
  ent auditor evaluates the evidence underlying management's
  financial statements and, based upon this work, expresses an opin-
  ion on the statements. This process adds credibility to management's
  financial statements.
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.

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 for performing an audit. (See appendix B for a listing of these standards.) The standards establish criteria for the auditor's professional qualifications, the nature and extent of judgments exercised in the audit, and the preparation of the auditor's report. These standards apply equally in any financial statement audit, regardless of the type or size of the entity.

- "Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement." This statement describes the objective of the audit. The auditor will, among other matters, obtain an understanding of the client's business and its internal control structure, perform analytical procedures, and collect sufficient, competent evidence based upon the perceived risk of material misstatement identified in planning the audit. The objective of an audit is to obtain reasonable assurance that the financial statements are free of material errors, fraud, or other misstatements in the financial statements. Misstatements are considered to be material if they are significant enough to affect the decisions of a reasonable financial statement user.

- "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." The basis for an audit opinion is the evidence collected by the auditor. The auditor performs auditing procedures to gather this evidence. For example, the CPA will normally examine or observe assets, confirm transactions with third parties, examine contracts or other documentary evidence supporting transactions, and perform analytical procedures to evaluate the balances and transactions presented in financial statements.
Usually, the auditor examines evidence on a test basis. The auditor cannot economically evaluate every transaction, even for a small business. As a result of such testing, it is possible that carefully performed audit tests may not disclose evidence of existing material misstatements.

When performing audit tests, the auditor assesses the appropriateness of the accounting principles used, significant estimates made, and the overall financial statement presentation. The auditor is trained to understand accounting principles and situations when their application is appropriate. The auditor is also skilled in the evaluation of accounting estimates. These evaluations are a significant aspect of the audit.

- "We believe that our audits provide a reasonable basis for our opinion." This sentence implies that the auditor used professional judgment in conjunction with knowledge about the Company's specific circumstances to determine what, when, and how much to test. The auditor explicitly states that he or she believes the evidence was sufficient to form an opinion on the financial statements taken as a whole.

**Opinion Paragraph**

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, 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.

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

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

- "present fairly, . . . in conformity with generally accepted accounting principles." The phrase present fairly must always be coupled with in conformity with generally accepted accounting principles (or another appropriate basis of accounting) when reading the auditor's report. The two phrases are indivisibly linked to form a single concept of fair presentation. Generally accepted accounting principles are the standards by which the auditor evaluates the overall fairness of financial statements.

- "In all material respects" reemphasizes materiality. The phrase indicates that financial statements cannot be accurate in an absolute sense; they can only be reasonably accurate.
Signature and Report Date

D. LaRusso & Co.
Certified Public Accountants

February 14, 19X3

The auditor's report is signed with the CPA firm name because the firm assumes responsibility for the audit. The date of the auditor's report is important because this represents the date (usually the date when fieldwork was completed) that the auditor obtained reasonable assurance about whether the financial statements are free of material misstatements. The auditor takes responsibility for the existence of material uncertainties, significant subsequent events, or indications of substantial doubt about going concern problems through the date of the auditor's report.
Chapter 6

Nonstandard Auditor's Reports

The following factors prevent the auditor from issuing a standard report:

- Circumstances may require additional explanatory language in the standard report, but not a modification of the auditor's opinion, because they do not change the auditor's conclusions about the financial statements.
- Circumstances may require a modification of both the wording of the standard report and the auditor's opinion on the financial statements.

Has the Auditor's Unqualified Opinion Changed?

Financial statement readers should understand the distinction between the terms auditor's report and auditor's opinion. The auditor's report is the entire communication for financial statement readers. The auditor's opinion communicates (in the opinion paragraph of the independent auditor's report) the auditor's conclusions about fair presentation, in all material respects, of the financial statements in accordance with generally accepted accounting principles.

If the auditor concludes that the financial statements fairly present, in all material respects, financial position, results of operations, and cash flows in accordance with GAAP, he or she will issue an unqualified opinion on the statements. At the same time, circumstances may require the auditor to communicate additional information to the user. Such information is communicated through additional explanatory language. Following are some circumstances that may necessitate the use of additional explanatory language:

- Reliance on Other Auditors
- Changes in Accounting Principles
- Material Uncertainties
- Going Concern Problems
- Emphasis of a Matter
Examples of auditor's reports with explanatory wording and *unqualified opinions* are described on pages 23 to 27. Page 28 illustrates a similar report when the auditor reports on financial statements prepared in accordance with a comprehensive basis of accounting other than GAAP.

Other circumstances lead the auditor to depart from an *unqualified opinion* on the financial statements. If the auditor concludes that a limitation on the scope of the audit prevents the forming of an opinion on the financial statements (in part or in total), then he or she will qualify or disclaim an opinion. If the auditor believes that material departures from GAAP exist in the financial statements, he or she will issue a qualified or adverse opinion. In each case, the auditor will refer to a separate paragraph that explains the qualification. Examples of auditor's reports where the opinion on the financial statements is other than unqualified are described on pages 29 to 33.
Auditor's Reports With Additional Explanatory Wording

Referring to the Report of Another Independent Auditor
[Emphasis provided for explanatory wording]

Independent Auditor’s Report

To MLJ Company and its Board of Directors:

We have audited the consolidated balance sheets of MLJ Company as of December 31, 19X2 and 19X1, and the related consolidated 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. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets of $23,000,000 and $20,000,000 as of December 31, 19X2 and 19X1, respectively, and total revenues of $50,000,000 and $45,000,000 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 B Company, is based solely on the report of the other auditors.

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 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of MLJ 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.

February 14, 19X3

D. LaRusso & Co.
Certified Public Accountants
Reason for the Explanatory Wording

The final explanatory paragraph is added to the auditor's report when management changes accounting principles (such as changing from accelerated to straight-line depreciation) or the method of applying accounting principles (such as a significant change in the method of determining pension liabilities or applying the percentage-of-completion method of accounting for long-term contracts) that have a material impact on the comparability of financial statements among the periods presented.

Meaning

The purpose of the additional paragraph is to highlight accounting changes for the financial statement user. Furthermore, the user can infer from this opinion that management has provided reasonable justification for the change and that the auditor concurs with the reasons for the accounting change.

If the auditor does not concur with an accounting change, the auditor will express a qualified opinion because of a departure from generally accepted accounting principles (see page 32).

Changes in Accounting Principles

[Emphasis provided for nonstandard wording]

Independent Auditor's Report

To MLJ Company and its Board of Directors:

We have audited the accompanying balance sheets of MLJ 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.

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.

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, 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.

As discussed in Note X to the financial statements, the Company changed its method of computing depreciation in 19X2.

February 14, 19X3

D. La Russo & Co.
Certified Public Accountants
Material Uncertainties
[Emphasis provided for modified wording]

Independent Auditor's Report

To MLJ Company and its Board of Directors:

We have audited the accompanying balance sheets of MLJ 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.

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.

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, 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.

As discussed in Note X to the financial statements, the Company is a defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counteraction, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the litigation cannot presently be determined. Accordingly, no provision for any liability that may result upon adjudication has been made in the accompanying financial statements.

D. LaRusso & Co.
Certified Public Accountants

February 14, 19X3
Reason for the Explanatory Wording

When the auditor concludes that there is substantial doubt about the client's ability to continue as a going concern for a reasonable period of time (see page 12), an explanatory paragraph is included in the report. The explanatory paragraph references the financial statement note where the uncertainty about the entity's ability to continue as a going concern and management's plans regarding the uncertainty are addressed.

Meaning

If substantial doubt exists about the ability of a company to continue as a going concern for a reasonable period of time, it is also uncertain whether the financial statements should be adjusted and in what amounts. For example, it may be uncertain whether long-term assets should be revalued by using a liquidation basis of accounting. The explanatory paragraph alerts the reader to the auditor's conclusion of substantial doubt about the company's ability to continue as a going concern.

The standard auditor's report does not contain any statements about the entity as a going concern. The absence of an explanatory paragraph referring 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.

Going Concern Problems

[Emphasis provided for nonstandard wording]

Independent Auditor's Report

To MLJ Company and its Board of Directors:

We have audited the accompanying balance sheets of MLJ 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.

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.

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, 19X2, and the results of its operations and its cash flows for the year then ended, in conformity with generally accepted accounting principles.

The accompanying financial statements have been prepared assuming that MLJ Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a 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 X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

February 14, 19X3

D. LaRusso & Co.
Certified Public Accountants
Emphasis of a Matter

[Emphasis provided for nonstandard wording]

Independent Auditor's Report

To MLJ Company and its Board of Directors:

We have audited the accompanying balance sheets of MLJ 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.

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.

As discussed in Note X 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.

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, 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.

February 14, 19X3

D. LaRusso & Co.
Certified Public Accountants

Reason for the Explanatory Wording

The auditor may wish to emphasize a matter in the financial statements as well as express an unqualified opinion. In this example, the auditor has chosen to highlight the note on related party transactions for financial statement readers. Nevertheless, the financial statements are fairly presented in all material respects.

Meaning

As shown here, the scope of the audit and the opinion expressed by the auditor do not differ from the standard report. The auditor merely emphasizes certain disclosures in the financial statements.
Reason for the Explanatory Wording

Some companies prepare their financial statements using a basis of accounting other than GAAP. The income tax basis and cash basis of accounting are among the comprehensive bases of accounting for the purpose of preparing financial statements. An auditor may express an opinion on the fair presentation of financial statements prepared on these bases.

Meaning

The introductory paragraph is modified by changing financial statement names to highlight the fact that the basis of accounting is other than GAAP.

The scope paragraph is the same as in the standard report, indicating that the auditor has applied the same generally accepted auditing standards when auditing these financial statements.

The third paragraph is an explanatory paragraph that refers the reader to the note in the financial statements that describes the basis of accounting, which is a comprehensive basis of accounting other than GAAP.

The opinion paragraph, like the introductory paragraph, is modified only to reflect the basis of accounting used to prepare the financial statements. In this example, the auditor issues an unqualified opinion on the fair presentation, in all material respects, of the financial statements in accordance with the income tax basis of accounting.

Report on Financial Statements Prepared on a Comprehensive Basis of Accounting Other Than GAAP

Financial Statements Prepared on the Entity’s Income Tax Basis

[Emphasis provided for nonstandard wording]

Independent Auditor’s Report

To the Partners, R&MJ Partnership:

We have audited the statements of assets, liabilities and capital—income tax basis of R&MJ Partnership as of December 31, 19X2 and 19X1, 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 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.

As described in Note X, the financial statements were prepared on the accounting basis used 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 R&MJ Partnership as of December 31, 19X2 and 19X1, and its revenue and expenses and changes in partners’ capital accounts for the years then ended, on the basis of accounting described in Note X.

February 14, 19X3

D. LaRusso & Co.
Certified Public Accountants
Auditor's Reports With Other Than Unqualified Opinions

Qualified Opinion Because of a Limitation on the Scope of the Audit
[Emphasis provided for nonstandard wording]

Independent Auditor's Report

To MLJ Company and its Board of Directors:

We have audited the accompanying balance sheets of MLJ 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.

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits 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 $3,000,000 and $2,500,000 at December 31, 19X2 and 19X1, respectively, or its equity in earnings of that affiliate of $400,000 and $300,000, which is included in net income for the years then ended as described in Note X 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, 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.

February 14, 19X3

Reason for the Qualified Opinion

The auditor issues a qualified, except for opinion because of a scope limitation when the circumstances surrounding the audit, or the client, restrict the CPA's ability to collect sufficient evidence to provide a reasonable basis for the CPA's opinion.

Meaning

In the paragraph immediately preceding the opinion paragraph, the auditor explains the limitation on the scope of the audit. In this example, the auditor was unable to collect sufficient evidence on the value of the Company's investment in the foreign subsidiary. The auditor also explains the monetary amounts in the financial statements that he or she was unable to audit.

In the opinion paragraph, the auditor points out that the financial statements may or may not have been adjusted if the auditor had had no restriction on the scope of audit procedures.
Reason for the Disclaimer of Opinion

An auditor will disclaim opinion when he or she has not obtained sufficient evidence to form an opinion on the financial statements. The difference between a qualified opinion and a disclaimer of opinion because of a limitation on the scope of the audit is a matter of magnitude. As shown here, the lack of evidence supporting inventories and property and equipment was so material that the auditor could not express an opinion on the financial statements as a whole.

Meaning

Because the auditor does not express an opinion on the financial statements, no assurance is provided by this auditor's report. The last sentence of the introductory paragraph and the scope paragraph were omitted from the report because the auditor was unable to obtain evidential matter to support an opinion about whether the financial statements were free of material misstatement. The paragraph immediately preceding the disclaimer paragraph explains the limitation on the scope of the audit that prevented the auditor from expressing an opinion.

Disclaimer of Opinion Because of a Limitation on the Scope of the Audit

[Emphasis provided for changes from standard wording]

Independent Auditor's Report

To MLJ Company and its Board of Directors:

We were engaged to audit the accompanying balance sheets of MLJ 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.

[The last sentence of the introductory paragraph is omitted.]

[The scope paragraph is omitted.]

The Company did not make a count of its physical inventory in 19X2 or 19X1, stated in the accompanying financial statements at $1,200,000 as of December 31, 19X2, and $950,000 as of December 31, 19X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19X1 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.

February 14, 19X3

D. LaRusso & Co.
Certified Public Accountants
To MLJ Company and its Board of Directors:

We have audited the accompanying balance sheets of MLJ 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.

Except as explained in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform our 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 did not observe the taking of the physical inventory as of December 31, 19X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures.

Because of the matter discussed in the preceding paragraph, the scope of our work regarding inventories as of December 31, 19X0, was not sufficient to enable us to express, and we do not express, an opinion on the statements of income, retained earnings, and cash flows for the year ended December 31, 19X1.

In our opinion, the balance sheets of MLJ Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 19X2, present fairly, in all material respects, the financial position of MLJ Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the year ended December 31, 19X2, in conformity with generally accepted accounting principles.

D. LaRusso & Co.
Certified Public Accountants

February 14, 19X3
Qualified Opinion Because of a Departure From GAAP
[Emphasis provided for nonstandard wording]

Independent Auditor's Report

To MLJ Company and its Board of Directors:

We have audited the accompanying balance sheets of MLJ 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.

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.

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 $5,000,000 and $5,500,000, long-term debt would be increased by $7,000,000 and $7,200,000, and retained earnings would be decreased by $2,000,000 and $1,700,000 as of December 31, 19X2 and 19X1, respectively. Additionally, net income would be decreased by $650,000 and $500,000 and earnings per share would be decreased by $.65 and $.50, 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, 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.

D. LaRusso & Co.
Certified Public Accountants

February 14, 19X3
Adverse Opinion

[Emphasis provided for nonstandard wording]

Independent Auditor's Report

To MLJ Company and its Board of Directors:

We have audited the accompanying balance sheets of MLJ 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.

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.

As discussed in Note X 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, 19X2 and 19X1, inventories have been increased $500,000 and $450,000 by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is carried at $15,000,000 and $12,500,000 in excess of an amount based on the cost to the Company; and deferred income taxes of $4,000,000 and $2,500,000 have not been recorded; resulting in an increase of $5,000,000 and $2,950,000 in retained earnings and in appraisal surplus of $15,000,000 and $12,500,000, respectively. For the years ended December 31, 19X2 and 19X1, cost of goods sold has been increased $500,000 and $350,000, respectively, because of the effects of the depreciation accounting referred to above and deferred income taxes of $1,500,000 and $1,000,000 have not been provided, resulting in an increase in net income of $1,000,000 and $650,000, 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 generally accepted accounting principles, the financial position of MLJ Company as of December 31, 19X2 and 19X1, or the results of its operations or its cash flows for the years then ended.

D. LaRusso & Co.
Certified Public Accountants

February 14, 19X3
Chapter 7

Summary

Financial statements are the representations of management. Readers of financial statements use them for a variety of purposes and decisions. For example, financial statements are used by investors for making decisions about whether to buy or sell securities, by credit-rating services for making decisions about creditworthiness of entities, and by bankers for making decisions about whether to lend money. When using management’s statements, the reader must recognize the inherent limitations that arise from the use of accounting estimates and judgments, as well as from the use of alternative accounting principles and methods that are acceptable within the context of GAAP.

The objective of an audit is to add credibility to management’s representations in financial statements. In an audit, the financial statements are evaluated by an impartial expert who is knowledgeable about auditing and accounting, including financial reporting matters. The auditor addresses the fair presentation of management’s financial statement representations and provides reasonable assurance that they are free of material misstatements.

The independent CPA collects evidence during the audit to obtain reasonable assurance that the amounts and disclosures in the financial statements are free of material misstatement. However, the characteristics of evaluating evidence on a test basis, the fact that accounting estimates are inherently imprecise, and the difficulties associated with detecting misstatements hidden by means of collusion and careful forgery, prevent the auditor from finding every error or irregularity that may affect a user’s decision.

The auditor also evaluates whether audit evidence raises substantial doubt about the ability of the client to continue as a going concern for a reasonable period of time. However, readers should recognize that future business performance is uncertain, and an auditor cannot guar-
antee business success. Lack of reference to going concern issues should not be viewed as providing assurance about an entity's ability to continue as a going concern.

The independent audit, through the process of examining evidence underlying the financial statements, adds credibility to management's representations in the statements. In turn, the audit provides investors, bankers, creditors, and others with reasonable assurance that the financial statements are free of material misstatement.
Appendix A

Standard Review and Compilation Reports

The Standard Review Report

To MLJ Company and its Board of Directors:

We have reviewed the accompanying balance sheets of MLJ Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with standards established by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of management of MLJ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

February 14, 19X3

D. LaRusso & Co.
Certified Public Accountants

Purpose of the Review Report

This report is issued by a CPA engaged to express limited assurance on the financial statements of a private company. The independent CPA provides negative assurance in a review report as a result of performing analytical procedures and inquiries of management.

Meaning

Professional standards for performing a review of financial statements do not contemplate obtaining an understanding of an entity’s internal control structure, assessing control risk, testing accounting records and responses to inquiries by obtaining corroborating evidential matter, or certain other procedures ordinarily performed during an audit. A review provides some assurance about management’s representation in financial statements, but substantially less assurance than an audit provides (see figure 2, page 9). A review provides assurance that nothing came to the CPA’s attention that would have a material impact on the financial statements—a level of assurance referred to as limited or negative assurance.
Purpose of the Compilation Report

Frequently, a small business will engage a CPA to present, in the form of financial statements, information that is the representation of management of a private company. The CPA ordinarily is not required to make inquiries or perform procedures to verify, corroborate, or review the information supplied by the client. However, the CPA has a responsibility to—

- Acquire knowledge about the accounting principles and practices of the industry in which the client operates to enable the CPA to compile financial statements that are in a form appropriate for an entity operating in that industry.
- Obtain a general understanding of the nature of the client's business transactions, the form of its accounting record, the stated qualifications of its accounting personnel, the accounting basis on which the financial statements are to be presented, and the form and content of the financial statements.
- Read the compiled financial statements and consider whether they appear to be appropriate in form and free from obvious material errors.

Meaning

Since the CPA is not obliged to verify the underlying data, no assurance is given on the conformity of the financial statements with GAAP. Audits have value because they provide reasonable assurance that management's representations embodied in the financial statements are free of material misstatement. Reviewed financial statements offer the user a limited level of assurance. The user of compiled financial statements should understand that the financial statements are the representations of management, and, in this case, no assurance is provided by the CPA.

The Standard Compilation Report

To MLJ Company and its Board of Directors:

We have compiled the accompanying balance sheets of MLJ Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with standards established by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

D. LaRusso & Co.
Certified Public Accountants

February 14, 19X3
Appendix B

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 Fieldwork

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmation to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

1. The report shall state whether the financial statements are prepared 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 disclosure in the financial statements is to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall either contain 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 therefor 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 and the degree of responsibility the auditor is taking.