

ACC531: Auditing and Assurance Services  
Ch12. Auditors' Reports

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- 1 Overview of Auditors' Reports
- 2 Conditions That Require Modifications
- 3 Auditors' Reports Referencing Other Matters

## Motivating Example: COVID-19 and the Audit Report

Norwegian Cruise Lines (NCLH) and Carnival (CCL) were both audited by PwC and found to present F/S fairly in accordance with GAAP — yet their reports differed.

	Norwegian (NCLH)		Carnival (CCL)	
	2019	2020	2019	2020
Revenues (\$B)	\$6.5	<u>\$1.3</u>	\$20.8	<u>\$5.6</u>
Operating income (\$B)	\$1.2	<u>(\$1.4)</u>	\$3.3	<u>(\$8.9)</u>
Net income (\$B)	\$0.9	<u>(\$4.0)</u>	\$3.0	<u>(\$10.2)</u>
Cash flow from ops (\$B)	\$1.8	<u>(\$2.6)</u>	\$5.4	<u>(\$6.7)</u>
Liabilities-to-assets	0.60	<u>0.74</u>	0.44	<u>0.61</u>

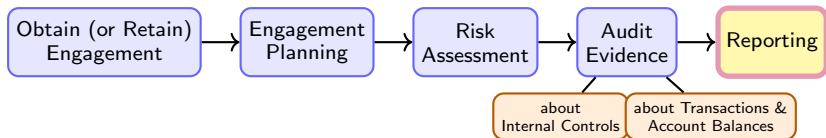
Both received **unmodified opinions** — F/S conform to GAAP. PwC added an **Emphasis-of-Matter** paragraph for COVID-19 uncertainty; EY referenced COVID-19 for AMC Entertainment but **not** for Wynn Resorts, Marriott, or American Airlines despite similar impacts. This illustrates the judgment auditors exercise in deciding what additional information belongs in the report.

## LO 12-1

Identify the reports that accompany an entity's financial statements and the content of the auditors' standard (unmodified) report.

## Where Are We in the Audit?

- After gathering **sufficient appropriate evidence**, auditors must **communicate** their conclusions to stakeholders.
- The **auditors' report** is the primary output delivered to financial statement users.
- Ch12 covers the reporting stage: which reports are issued and when opinions are modified.



## Four Types of Audit Opinions

Opinion	Key phrase	When issued
Unmodified	“present fairly...”	F/S conform to GAAP
Qualified	“except for...”	Material but not pervasive issue
Adverse	“do not present fairly”	Material & pervasive GAAP departure
Disclaimer	no opinion expressed	Material & pervasive scope limitation

- Most common: \_\_\_\_\_ — the “clean opinion”
- Modified opinions arise from
  - ▶ \_\_\_\_\_ from GAAP
  - ▶ scope limitations

- 1 Title: “Independent Auditor’s Report”
- 2 Addressee
- 3 **Opinion Paragraph** — the auditor’s conclusion
- 4 Basis for Opinion
- 5 Responsibilities of Management
- 6 Auditor’s Responsibilities for the Audit

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<sup>1</sup>Applies to [nonissuers](#) (private companies) under AICPA/GAAS standards. Issuers (public companies) follow PCAOB standards with additional required sections.

### (3) Opinion Paragraph

- “In our opinion, the accompanying financial statements present \_\_\_\_\_, in all material respects, the financial position of [Entity]... in accordance with GAAP.”

### (4) Basis for Opinion

- “We conducted our audit in accordance with \_\_\_\_\_.”
- Auditors are required to be independent and meet their ethical responsibilities.

## (5) Responsibilities of MGT

- Preparation and fair presentation of F/S
- Design and maintain internal control
- Assess ability to continue as a going concern

## (6) Responsibilities of Auditors

- Obtain \_\_\_\_\_ that F/S are free of material misstatement
- Exercise professional judgment and professional skepticism
- Identify and assess risks of material misstatement
- Evaluate appropriateness of accounting policies
- Conclude on going concern

## Issuers vs. Nonissuers

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	<b>Issuers (Public Co.)</b>	<b>Nonissuers (Private Co.)</b>
Standards	<u>PCAOB</u> standards	<u>AICPA/GAAS</u> standards
Oversight	SEC, PCAOB	AICPA
IC Report	Required (SOX §404) <sup>2</sup>	Not required

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<sup>2</sup>For AFs (Accelerated Filers), auditors must also report on the effectiveness of ICOFR.

- 1 Which section of the standard (unmodified) report states that the audit was conducted in accordance with GAAS? \_\_\_\_
- A) Opinion Paragraph
  - B) Basis for Opinion
  - C) Responsibilities of Management
  - D) Auditor's Responsibilities
- 2 [T/F] The standard (unmodified) auditors' report states that the financial statements present fairly "in all material respects." \_\_\_\_
- 3 [T/F] A standard (unmodified) opinion states that the financial statements present fairly "except for" certain departures. \_\_\_\_

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# Conditions That Require Modifications

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## LO 12-2

Identify situations in which language in the standard (unmodified) report is modified and the type of opinion issued in those situations.

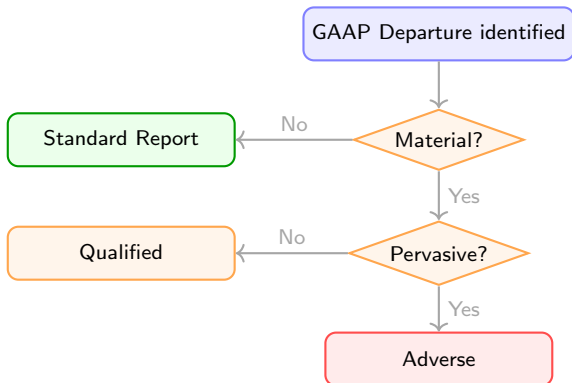
## Two Conditions Requiring Modifications

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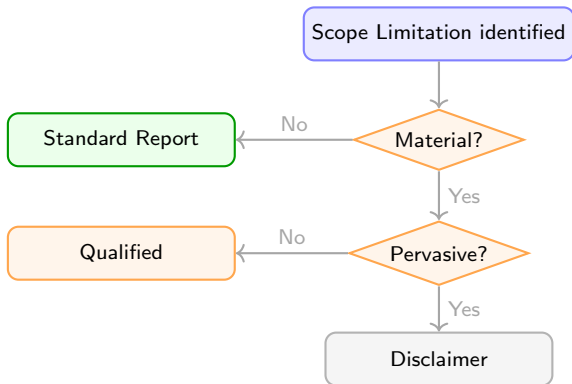
Condition	Description	Possible Opinions
GAAP Departure	F/S do <b>not conform</b> to GAAP in some material respect	Qualified; Adverse
Scope Limitation	Auditor <b>could not obtain</b> sufficient appropriate evidence	Qualified; Disclaimer

Key driver: how \_\_\_\_\_ the issue is.

## Decision Framework: GAAP Departure



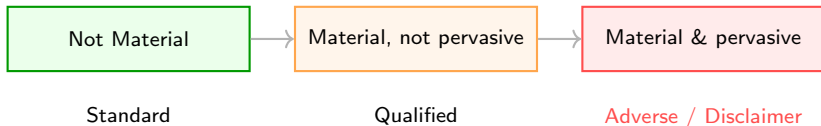
## Decision Framework: Scope Limitation



## What Is “Pervasive”?

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- **Pervasive**: the issue affects the F/S as a whole — not limited to specific accounts or disclosures.
- Auditors apply professional judgment; no bright-line threshold.



## GAAP Departure: Qualified vs. Adverse Opinion

	Qualified	Adverse
Severity	Material, <u>not pervasive</u>	Material, <u>pervasive</u>
Wording	“except for the <i>effects</i> . . .”	“do <u>not</u> present fairly. . .”
Basis para.	Departure + financial effect	Why F/S are misleading as a whole

Most of the time,

- Clients typically correct GAAP departures to avoid an adverse opinion.
- Otherwise, the auditor will issue an adverse opinion.

## Scope Limitation: Qualified vs. Disclaimer

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- Scope limitation: auditor **could not obtain** sufficient appropriate evidence
  - ▶ client-imposed (e.g., denied access to records)
  - ▶ circumstantial (e.g., records destroyed by fire)

	<b>Qualified</b>	<b>Disclaimer</b>
Severity	Material, <b>not pervasive</b>	Material, <b>pervasive</b>
Wording	“except for the <i>possible effects</i> ...”	“we do <b>not express an opinion</b> ...”
Basis para.	Describes scope limitation	Describes scope limitation

- 1 A client departed from GAAP in a way that is material and pervasive. Which opinion should the auditor issue? \_\_\_\_
- A) Unmodified
  - B) Qualified
  - C) Adverse
  - D) Disclaimer
- 2 [T/F] A scope limitation that is material but not pervasive results in a disclaimer of opinion. \_\_\_\_
- 3 [T/F] When a client refuses to allow the auditor to observe physical inventory, this is an example of a client-imposed scope limitation. \_\_\_\_

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### LO 12-3

Identify situations in which auditors add explanatory language to an unmodified opinion.

## Explanatory Paragraphs: Overview

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- Sometimes the opinion is **unmodified**, but auditors add **explanatory paragraphs** to draw attention to important matters.
- These paragraphs **do not change** the opinion — they provide additional context.

Consistency  
Paragraph

Going Concern  
Paragraph

Emphasis-of-Matter  
Paragraph

All three appear after the Basis for Opinion paragraph in the report.

- When a client changes from one **acceptable** accounting principle to another, an explanatory **consistency paragraph** is required.
- The paragraph identifies: the nature of the change, the period, and refers to the footnote explaining the change.

### Examples

- Change from FIFO to LIFO inventory costing
- Change from straight-line to accelerated depreciation
- Correction of a **material error** (restatement)

## Going Concern: Substantial Doubt

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- Auditors must assess whether **substantial doubt** exists about the entity's ability to continue as a going concern for at least 12 months after the report date.

Recurring  
operating losses

Negative  
cash flows

Working capital  
deficiency

Debt covenant  
violations

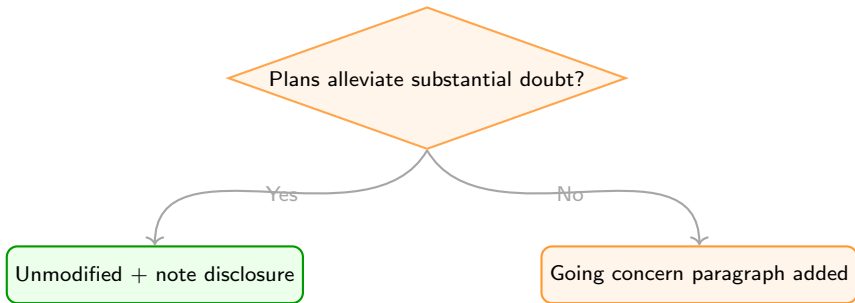
Pending  
litigation

Loss of key  
customers

If conditions exist, MGT must develop a plan to mitigate the doubt.

## Going Concern: Auditor's Response

- Auditor evaluates whether MGT's **mitigation plans** (asset sales, cost cuts, new financing, debt restructuring) are sufficient to alleviate substantial doubt.
- If \_\_\_\_\_ remains: add a going-concern paragraph to an otherwise unmodified report.



## Practice Questions

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- 1 Which of the following would most likely cause an auditor to add a going concern paragraph to an otherwise unmodified report? \_\_\_\_
- A) The client changed its inventory costing method from FIFO to LIFO
  - B) The client has recurring operating losses that raise substantial doubt about its ability to continue as a going concern
  - C) The auditor identified an immaterial misstatement in the prior year
  - D) The client's audit was completed 45 days after year-end
- 2 [T/F] Adding a consistency paragraph changes the auditor's opinion from unmodified to qualified. \_\_\_\_
- 3 [T/F] An auditor must add an explanatory paragraph when a client changes from one acceptable accounting principle to another. \_\_\_\_

Opinion	Trigger	Pervasiveness	Key Language
<u>Unmodified</u>	No issues	—	“present fairly ...”
<u>Qualified</u>	GAAP departure	Material, not pervasive	“except for ...”
<u>Qualified</u>	Scope limitation	Material, not pervasive	“except for the possible effects ...”
<u>Adverse</u>	GAAP departure	Pervasive	“do not present fairly ...”
<u>Disclaimer</u>	Scope limitation	Pervasive	No opinion expressed

**Explanatory paragraphs** (opinion stays unmodified):

- Consistency: accounting principle changed; criteria met ⇒ other-matter paragraph
- Going concern: substantial doubt exists ⇒ emphasis-of-matter paragraph; disclosure required
- Emphasis of matter: other information fundamental to users' understanding (e.g., COVID-19)