Tenth Edition

CPA

Preparatory Program

Audit

Sample Chapters:
Planning the Engagement &
Unmodified Opinions

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Area II

Content Group A. Planning the Engagement (AU-C 300)

The first step in the performance of an audit is the planning of the audit. While the initial plan is important, the auditor must remember that the plan may be changed throughout the audit. The plan is developed with the knowledge and information that the auditor has at that time. As the audit is performed more information will become known to the auditor. Based on this information they may learn that the initial plan is no longer the correct plan and it will need to be adjusted.

During the planning phase is a good time to recall that the goal of the audit is to express an opinion on the financial statements. All of the work done during the audit and all of the evidence collected is done with the goal of expressing an opinion. If, after performing all of the scheduled work, the auditor is not able to express an opinion, they will need to do additional work.

If the planning process is properly done, there will be a lot of benefits throughout the audit. Among them are:

- Appropriate time will be devoted to the important areas of the audit.
- The auditor will be able to better identify and resolve issues in a timely manner.
- The audit will be performed in an effective and efficient manner.

AU-C 300 outlines the role of planning in the engagement.

.02 Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following:

- Helping the auditor identify and devote appropriate attention to important areas of the audit
- Helping the auditor identify and resolve potential problems on a timely basis
- Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner
- Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks and allocating team member responsibilities
- Facilitating the direction and supervision of engagement team members and the review of their work
- Assisting, when applicable, in coordination of work done by auditors of components and specialists

.04 The objective of the auditor is to plan the audit so that it will be performed in an effective manner.

The planning process should be carried out by the engagement partner and other key members of the engagement team. It is important to get individuals with the necessary experience and skills to be able to identify as many of the potential issues as possible during the planning phase. All team members will be engaged in discussions of the plan and the engagement, but the leaders in the planning process will be the more experienced members of the team. As is covered later, AU-C 315 requires that all team members be involved in a discussion about the susceptibility of the financial statements to misstatement. This discussion may be part of the planning process.

Specifically Required Planning Activities

As part of the planning process the auditor is required to:

1) Perform procedures required as part of the Quality Control process (discussed in more detail Area I, Content Group G)
2) Evaluate compliance with ethical requirements in accordance with AU-C 220 (Quality Control)
3) Establishing an understanding of the terms of the engagement (AU-C 210)

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Overall Engagement Planning

The planning process may be broken down into two parts:

1) Developing an overall engagement strategy, and

2) Developing a detailed engagement plan.

We will look at each part individually.

1. Developing an Overall Engagement Strategy

The overall engagement strategy will establish the scope, timing and direction of the audit that will then guide the development of the specific audit plan. AU-C 300 lists what the auditor should do in establishing the overall strategy:

.08 In establishing the overall audit strategy, the auditor should

a. identify the characteristics of the engagement that define its scope;

b. ascertain the **reporting objectives** of the engagement in order to **plan the timing of the audit** and the **nature of the communications** required;

c. consider the factors that, in the auditor's professional judgment, are **significant in directing** the engagement team's efforts;

d. **consider the results of preliminary engagement activities** and, when applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and

e. **ascertain the nature, timing, and extent of resources necessary** to perform the engagement.

The audit strategy will also assist the auditor in the completion of the required risk assessment procedures. It will help establish the resources that will be needed, including the level of experience needed and also the need for any specialists. It will also assist in determining how many resources will be needed in different areas of the audit. Decisions will also be made about the timing of the procedures; will they be performed in interim periods, or after year-end.

The involvement of component auditors will also be able to be established and determined during the strategy phase.

Appendix C of AU-C 300 provides an extensive list of considerations for the auditor to take into account in establishing the overall audit strategy. The entire Appendix is copied here. We do not recommend that you memorize it, but you should read it to be aware of some of the many issues that are involved in establishing the audit strategy.

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Appendix—Considerations in Establishing the Overall Audit Strategy (Ref: par. .07–.08 and .A9–.A12)

This appendix provides examples of matters the auditor may consider in establishing the overall audit strategy. Many of these matters also will influence the auditor's detailed audit plan. The examples provided cover a broad range of matters applicable to many engagements. Although some of the following matters may be required by other AU-C sections, not all matters are relevant to every audit engagement, and the list is not necessarily complete.

Characteristics of the Engagement

The following are some examples of characteristics of the engagement:

- The financial reporting framework on which the financial information to be audited has been prepared, including any need for reconciliations to another financial reporting framework
- Industry specific reporting requirements, such as reports mandated by industry regulators
- The expected audit coverage, including the number and locations of components to be included
- The nature of the control relationships between a parent and its components that determine how the group is to be consolidated
- The extent to which components are audited by other auditors
- The nature of the business divisions to be audited, including the need for specialized knowledge
- The reporting currency to be used, including any need for currency translation for the audited financial information
- The need for statutory or regulatory audit requirements (for example, the Office of Management and Budget Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations)
- Whether the entity has an internal audit function and, if so, whether (in which areas and to what extent) the work of the internal audit function can be used in obtaining audit evidence or whether internal auditors can be used to provide direct assistance
- The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them
- The expected use of audit evidence obtained in previous audits (for example, audit evidence related to risk assessment procedures and tests of controls)
- The effect of IT on the audit procedures, including the availability of data and the expected use of computer assisted audit techniques
- The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect on the audit of the information obtained during such reviews
- The availability of client personnel and data

Reporting Objectives, Timing of the Audit, and Nature of Communications

The following examples illustrate reporting objectives, timing of the audit, and nature of communications:

- The entity's timetable for reporting, including interim periods
- The organization of meetings with management and those charged with governance to discuss the nature, timing, and extent of the audit work
- The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters, and communications to those charged with governance

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- The discussion with management regarding the expected communications on the status of audit work throughout the engagement
- Communication with auditors of components regarding the expected types and timing of reports to be issued and other communications in connection with the audit of components
- The expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed
- Whether there are any other expected communications with third parties, including any statutory or contractual reporting responsibilities arising from the audit

Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements

The following examples illustrate significant factors, preliminary engagement activities, and knowledge gained on other engagements:

- The determination of materiality, in accordance with section 320, Materiality in Planning and Performing an Audit, and, when applicable, the following:

— The determination of materiality for components and communication thereof to component auditors in accordance with section 600, Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)

— The preliminary identification of significant components and material classes of transactions, account balances, and disclosures

- Preliminary identification of areas in which there may be a higher risk of material misstatement
- The effect of the assessed risk of material misstatement at the overall financial statement level on direction, supervision, and review
- The manner in which the auditor emphasizes to engagement team members the need to maintain a questioning mind and exercise professional skepticism in gathering and evaluating audit evidence
- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified deficiencies and action taken to address them
- The discussion of matters that may affect the audit with firm personnel responsible for performing other services to the entity
- Evidence of management's commitment to the design, implementation, and maintenance of sound internal control, including evidence of appropriate documentation of such internal control
- Volume of transactions, which may determine whether it is more efficient for the auditor to rely on internal control
- Importance attached to internal control throughout the entity to the successful operation of the business
- Significant business developments affecting the entity, including changes in IT and business processes; changes in key management; and acquisitions, mergers, and divestments
- Significant industry developments, such as changes in industry regulations and new reporting requirements
- Significant changes in the financial reporting framework, such as changes in accounting standards
- Other significant relevant developments, such as changes in the legal environment affecting the entity

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Nature, Timing, and Extent of Resources

The following examples illustrate the nature, timing, and extent of resources:

- The selection of the engagement team (including, when necessary, the engagement quality control reviewer [see section 220, Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards]) and the assignment of audit work to the team members, including the assignment of appropriately experienced team members to areas in which there may be higher risks of material misstatement
- Engagement budgeting, including considering the appropriate amount of time to set aside for areas in which there may be higher risks of material misstatement

2. Developing a Detailed Engagement Plan

While the development of a detailed plan is a large project and process, the auditor will usually not be starting from a blank sheet of paper. For continuing clients, the previous period audit plan will serve as a starting point for the current year. However, it is not good to simply reperform the previous year audit, no matter who good the plan was. There should be some variation in audit procedures so that the client does not know what will be tested and how it will be tested. The client's over familiarity with the audit procedures would increase the risk of the client being able to successfully hide something from the auditor.

When the client is a new engagement, the auditor will most likely start with a generic template that they will then adjust and modify based on the preliminary assessments that they do.

Whether it is a new client or a recurring client, the detailed audit plan that is developed should contain all of the specifics and details about the performance of the engagement. This includes:

- The nature and extent of risk assessment procedures
- The nature, timing and extent of further audit procedures at the relevant assertion level
- Other planned audit procedures that are required to be performed to comply with GAAS
- Plan of the nature, timing and extent of supervision and direction of team members and the review of their work

In addition to the auditor's work that will be in the detailed plan, there will also be information about what is expected from the client. This will include a schedule of documents that the client should provide as well as the time by which they will be provided. Any individuals of the client that will need to be available for the auditors and when they will need to be available should also be established.

AU-C 300 provides a comparison of the audit strategy and the detailed plan.

.A14 The audit plan is more detailed than the overall audit strategy in that it includes the nature, timing, and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops. For example, planning of the auditor's risk assessment procedures occurs early in the audit process. However, planning the nature, timing, and extent of specific further audit procedures depends on the outcome of those risk assessment procedures. In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances, and disclosures before planning all remaining further audit procedures.

As stated in the introduction to this topic, the audit plan may be changed during the audit as more information is obtained. Various things during the course of the audit can cause the need for a change to the plan, but most of them can be summarized as finding something different than expected, or finding contradictory evidence during the engagement.

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> **.A15** As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and, thereby, the resulting planned nature, timing, and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures. For example, audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

Considerations for Initial Audits

When the auditor is engaged in an initial audit of a client, one additional step that must be performed as part of the initial engagement is communication with the predecessor auditor. This is covered in Area I, Content Group C.

Documentation Requirements

Both the overall audit strategy and the audit plan need to be included in the audit documentation. Additionally, any significant changes made to the strategy or the detailed plan during the engagement must also be documented.

> **.A21** The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and communicate significant issues to the engagement team. For example, the auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing, and conduct of the audit.
>
> **.A22** The documentation of the audit plan is a record of the planned nature, timing, and extent of risk assessment procedures and further audit procedures at the relevant assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.
>
> **.A23** A record of the significant changes to the overall audit strategy and the audit plan and resulting changes to the planned nature, timing, and extent of audit procedures explain why the significant changes were made and why the overall strategy and audit plan were finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

Content Group B. Understanding and Entity and Its Environment (AU-C 315)

After the client appoints the auditor and the terms of the audit engagement are agreed-upon and documented in an engagement letter (or other written document), a key step in actually planning the audit is for the auditors to ensure that they are knowledgeable about the client’s business, in particular the client’s operations (including internal controls), the client’s industry and the environment that the client operates in. **This knowledge will enable the auditor to understand how the various business transactions may affect the financial statements and identify risks that could result in material misstatements in the financial statements.**

During the process of gaining an understanding of the client’s operations (including internal controls) and industry and environment that the client operates in, the auditors should begin to assess the risk of material misstatement at both the account and assertion levels. As discussed in the introduction, the auditor’s assessments of the risk of material misstatement, along with the set level of audit risk, determine the planning of the audit. In the next subsection, we discuss the specific factors auditors should know about their

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clients as outlined in AU-C 315, which provides an excellent discussion of the factors auditors must understand about their client's business.

Per **AU-C 315.12**, the auditor's understanding of the client's **entity and environment** consists of an understanding of the following **aspects** of the business:

1) Industry, regulatory, and other external factors.
2) Nature of the Entity
3) Selection and application of accounting policies
4) Objectives and strategies and the related business risks that might result in a material misstatement of the financial statements
5) Measurement and review of the entity's financial performance

1) Industry, Regulatory, and Other External Factors (AU-C 315.A25 – .A29)

Industry – With respect to the industry the client operates in, auditors should understand the competitive environment, technological developments that could present business risks/opportunities and about specific accounting methods for the industry (e.g. percentage of completion for construction companies).

Regulatory environment – With respect to the regulatory environment, auditors obviously need to know the accounting rules that are relevant to their client's business. Beyond accounting rules, it also is important for auditors to know about various laws/regulations that could either affect the company's ability to operate and/or result in regulatory fines or penalties that create liabilities if the company fails to comply with those laws/regulations. Examples of these types of laws/regulations include environmental laws, labor laws, work place safety laws, consumer protection laws and trade laws.

Other external factors – Auditors should also understand the general economic conditions the client's business operates in, any social trends that could affect the client's business' ability to operate and/or the value of certain assets, and any political instability that could adversely affect a client's operations. Interest rates, inflation rates and currency stability may be part of the assessment of external factors.

2) Nature of the Entity (AU-C 315.A30 – .A34)

The nature of an entity refers to the entity's operations, its ownership, governance, the types of investments that it is making and plans to make, the way that the entity is structured, and how it is financed. An understanding of the nature of an entity enables the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

These will impact the possibility of misstatements in the financial statements.

An understanding of the ownership, management, and other key personnel and their relations between owners and other people or entities is also important in determining whether **related-party transactions** have been identified and accounted for appropriately.

Gaining an understanding of the nature of the entity entails knowing the following areas:

Ownership structure

For example, is the company privately owned by a small number of owners (e.g., family owned), is it privately owned by a large number of investors. If the company is privately owned, do the owners plan to hold the company for many years, or do they intend to sell the company in the near future. Alternatively, is the company publically owned? If the company is publically owned, who are the primary shareholders (e.g., a small number of very large individual investors, institutional investors or a large number of smaller investors) and what are their objectives. It is important for auditors to know who the primary owners of the company are and their objectives because it can provide an indication of the amount of pressure management might have to misstate the financial statements. For example, managers of a private company that will not be sold

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anytime soon likely will have less pressure to misstate the financial statement than managers of private companies that will be sold.

Governance

Auditors should know client's governance structure, which refers to the system by which the client's company is directed and controlled.

There are external and internal stakeholders that influence corporate governance. In current business corporations, the main external stakeholder groups are shareholders, debtholders, trade creditors, suppliers, customers and communities affected by the corporation's activities. Internal stakeholders are the board of directors, executives (i.e. upper management), and other employees.

Operations

Different factors auditors should know about clients' operations include (but are not limited to) the following:

- The nature of the client's business, i.e., is the client a manufacturer, distributor, retailer, or service provider?
- The manufacturing process if applicable
- The products and/or services the client sells
- The client's organizational structure. The client may have a simple structure with one entity and one location or it could be more **complex** with subsidiaries or other components in **multiple locations**.
- Logistics, i.e., how does the client obtain raw materials and goods used in their products and services, and how does the client deliver finished goods to its customers.
- The client's key partners
- Extent of e-commerce
- The client's suppliers and customers
- The client's research and development (R&D) activities
- Employment arrangements (e.g., union vs. non-union)

Investments – Auditors should know their client's investments and the client's intentions for those investments.

Financing – Auditors should understand how a client finances its operations and/or any plans for expansion. In particular, auditors should know whether operations and expansions currently are (or will be) financed through debt, equity, or are they self-financed (i.e., from cash flow from operations) or a mix of these options.

Financial reporting – Auditors should understand clients' financial reporting processes. In particular, auditors should know and understand the client's major classes of transactions, account balances and disclosures; the procedures in which transactions are initiated, authorized, recorded and reported; how transactions map into accounts in the financial statements; how the client's financial reporting system captures non-transaction events that could affect financial statement assertions (for example a technological advancement is a non-transaction event that could make a client's inventory obsolete thereby making the valuation assertion for inventory more subject to violation); and the client's period end processes for preparing the financial statements

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3) Selection and Application of Accounting Policies (AU-C 315.A35)

Auditors should understand the clients' financial reporting processes, including the selection and application of accounting policies and any recent changes to them. In particular, auditors should know and understand:

- The client's major classes of transactions, account balances and disclosures;
- The procedures in which transactions are initiated, authorized, recorded and reported;
- How transactions map into accounts in the financial statements;
- How the client's financial reporting system captures non-transaction events that could affect financial statement assertions (for example a technological advancement is a non-transaction event that could make a client's inventory obsolete thereby making the valuation assertion for inventory more subject to violation); and
- The client's period end processes for preparing the financial statements

AU-C 315

.A35 An understanding of the entity's selection and application of accounting policies may encompass such matters as

- the methods the entity uses to account for significant and unusual transactions.
- the effect of significant accounting policies in controversial or emerging areas for which a lack of authoritative guidance or consensus exists.
- significant changes in the entity's accounting policies and disclosures and the reasons for such changes.
- financial reporting standards, and laws and regulations that are new to the entity and when and how the entity will adopt such requirements.
- the financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting standards.

4) Objectives and Strategies and the Related Business Risks That Might Result In a Material Misstatement of the Financial Statements (AU-C 315.A36 – .A42)

The entity conducts its business in the context of industry, regulatory, and other internal and external factors. To respond to these factors, the entity's management (or those charged with governance) define **objectives**, which are the overall plans for the entity. **Strategies** are the operational approaches by which management intends to achieve its objectives.

Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies.

Just as the external environment changes, the conduct of the entity's business is also dynamic and the entity's strategies, objectives and business risks change over time.

It is important for auditors to know and understand their clients' objectives, strategies, and business risks because there generally is a higher degree of pressure on management to misstate the financial statements when a company's objectives are not being met. So, if a company has unrealistic objectives, faulty strategies (either in design or operation), and very high business risks, then objectives likely are not being met and auditors likely should increase their assessment of the risk of material misstatement because there likely is a high degree of pressure on management to misstate the financial statements.

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AU-C 315

.A39 Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies, and related business risks that may result in a risk of material misstatement of the financial statements include

- industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- new products and services (a potential related business risk might be, for example, product liability is increased).
- expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
- new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation or a cost increase).
- regulatory requirements (a potential related business risk might be, for example, that legal exposure is increased).
- current and prospective financing requirements (a potential related business risk might be, for example, financing is lost due to the entity's inability to meet requirements).
- use of IT (a potential related business risk might be, for example, systems and processes are incompatible).
- the effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

5) Measurement and Review of the Entity's Financial Performance (AU-C 315.A43 – .A48)

Performance measures and their review indicate to the auditor aspects of the entity's performance that management and others consider important.

Performance measures, **whether external or internal**, create pressures on the entity that may motivate management to take action to improve the business performance or to misstate the financial statements. Obtaining an understanding of the entity's performance measures assists the auditor in considering whether such pressures result in management actions that may have increased the risks of material misstatement.

AU-C 315

.A45 Examples of internally generated information used by management for measuring and reviewing financial performance, and which the auditor may consider, include

- key performance indicators (financial and nonfinancial) and key ratios, trends, and operating statistics.
- period-on-period financial performance analyses.
- budgets; forecasts; variance analyses; segment information; and divisional, departmental, or other-level performance reports.
- employee performance measures and incentive compensation policies.
- comparisons of an entity's performance with that of competitors.

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Documentation of Procedures

The auditor should document the procedures that were performed to obtain an understanding of the entity and its environment.

.33 The auditor should include in the audit documentation the

a. discussion among the engagement team required by paragraph .11, the significant decisions reached, how and when the discussion occurred, and the audit team members who participated;

b. key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph .12 and each of the internal control components specified in paragraphs .15–.25, the sources of information from which the understanding was obtained, and the risk assessment procedures performed;

c. identified and assessed risks of material misstatement at the financial statement level and at the relevant assertion level, as required by paragraph .26; and

d. risks identified and related controls about which the auditor has obtained an understanding as a result of the requirements in paragraphs .28–.31.

Content Group C. Understanding an Entity's Internal Control

Note: This Content Group has five specific Topics listed in the syllabus. Because of the nature of the topic, four of these five are presented together and not separated out according to Topics. The Topic of IT General and Application Controls is presented separately. The topic Implications of an Entity Using a Service Organization is covered in the section of the materials dealing with Service Organizations.

A good place to start the discussion of internal controls is with the definition of internal control. This is given in AC-C 315.

AU-C 315

.04 Internal control. A process effected by those charged with governance, management, and other personnel that is designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives.

Note that the definition states that internal controls are the processes designed by a company to provide reasonable assurance that an entity's objectives will be achieved. There are three main categories of objectives listed are:

1) Reliability of financial reporting,

2) Effectiveness and efficiency of operations, and

3) Compliance with applicable laws and regulations.

Note: For the external auditor, the internal controls that are related to the reliability of financial reporting and compliance with applicable laws and regulations are the most applicable. The controls connected to the effectiveness and efficiency of operations may provide indirect support to the financial statements, but they will not be the emphasis of the auditor's work.

Internal control is the responsibility of both management and personnel of the company. The primary function of internal controls is to provide assurance that errors and/or fraud will be discovered quickly (with a reasonable promptness) and before they are reported in the financial statements. It is also important to discover errors before they become a liability or risk to the company in some other way.

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The fundamental concept behind internal control is the **separation (or segregation) of the duties**. This separation means that the same person should not perform two or more of these duties within an individual transaction cycle:

1) **Authorization** of transactions,
2) **Record keeping** (the journal entries and other records of events),
3) **Custody of assets** (physical control over the asset), and
4) The **periodic reconciliation** between the recorded amount (#2 above) and the actual amount (#3 above).

Incompatible functions are those functions that place any person in a position to both perpetrate and conceal errors or fraud in the normal course of his or her work responsibilities. This occurs when a person performs two of these three functions.

Some of the questions on the exam will deal with what specific functions should not be performed by the same person. Unfortunately, in some of the questions, it is sometimes very difficult to determine what exactly the person is supposed to be doing. In these cases, you simply need to think about the situation and then make a logical guess. Do not spend a great deal of time thinking and thinking about this.

Note: Segregation of duties is discussed in more detail later in the materials.

Limitations of Internal Controls

The auditor needs to be aware that no internal control system is perfect and able to prevent or detect every case of fraud or unethical behavior and every misstatement. However, a well-designed system will be better than a poorly designed one.

Inherent limitations will always exist even in the best-designed internal control systems. Inherent limitations are limitations that exist naturally and are unable to be eliminated. No matter how developed and complete the system of internal controls is, there will always be the potential for errors and fraud.

1) **Errors** (unintentional mistakes) may occur as a result of misunderstandings about the controls and their application or simple carelessness.
2) **Fraud** (intentional mistakes) may be perpetrated through collusion or management override (this is when management simply ignores the controls that are in place).

Because of these limitations in internal controls, no system is perfect. As such, internal controls provide only **reasonable assurance** that errors will be detected.

.A53 *Limitations of internal control*. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by the inherent limitations of internal control. These include the realities that **human judgment** in decision making can be faulty and that breakdowns in internal control can occur because of human error. For example, an error in the design of, or in the change to, a control may exist. Equally, the **operation of a control may not be effective**, such as when information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

.A54 Additionally, controls can be circumvented by the **collusion** of two or more people or inappropriate management override of internal control. For example, management may enter into undisclosed agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

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Management Override

Management override occurs when management intentionally does not follow the appropriate internal controls and procedures. Managers may do this because they do not think that the controls are applicable to them. All controls are applicable to all employees, so the override of controls is inappropriate and a violation of controls.

The override of controls by management is a significant risk for the company as it eliminates the controls that are in place to maintain the accuracy of the financial reporting.

Common ways in which managers override controls include:

- Changing the dates on documents
- Reclassifying information (for example, capitalizing something that should be expensed)
- Adjusting entries during the closing process
- Setting up false vendors and making payment to them
- Falsifying inventory reports

The specific reason that this occurs is not relevant, but common reasons include:

- Pressure to meet earnings forecasts or projections
- Their compensation is tied to financial results
- Attempt to meet debt covenants or loan requirements

The auditor needs to be aware of the possibility of management override in all of the areas that they are investigating.

Influences of Internal Controls

There are a number of items that will influence the internal control system of a company. This is not a list that you need to memorize, but simply be familiar with the types of things that do influence the internal control system. These influences may be both positive and negative, depending upon the extent or direction of the influence. For example, a business that is heavily regulated by the government (such as a bank) will have a positive influence on internal controls from their regulatory and legal requirements (Item 5 below).

- Method of information processing,
- Organization and ownership characteristics,
- Diversity and complexity of operations,
- Size of the entity,
- Regulatory and legal requirements, and
- Nature of the business.

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Components of Internal Control

There are five interrelated components that comprise internal control. Each of the components is discussed from the standpoint of internal controls and then there is coverage from AU-C 315 of the what the auditor is looking at in respect to the different components. The five components of a company's internal controls are:

1) Control Environment (AU-C 315.15)
2) The entity's risk assessment process (AU-C 315.16-.18)
3) The Information System (AU-C 315.19-.20)
4) Control Activities (AU-C 315.21-.22)
5) Monitoring (AU-C 315.23)

Component 1: The Control Environment

The control environment provides the foundation for all the other components. It influences the control consciousness of all the people in the organization, and sets the tone for the entire organization. Control environment factors include:

- The integrity, ethical values and competence of the entity's people;
- Management's philosophy and operating style;
- The way management assigns authority and responsibility and develops its people;
- The attention and direction provided by the board of directors.

Internal controls are more likely to function well if **management believes that the controls are important and communicates that support to employees at all levels.** If management believes controls are meaningless or even an obstacle, employees will pick up on this attitude. And in spite of formal policies saying otherwise, employees will then view internal controls as "red tape" to be "cut through" to get the job done.

A strong control environment helps the external auditor because this environment means that there is a greater chance of a misstatement being prevented or detected because the corporate culture creates an environment in which functioning internal controls are considered important.

.15 *Control environment*. The auditor should obtain an understanding of the control environment. As part of obtaining this understanding, the auditor should evaluate whether management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior and the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control and whether those other components are not undermined by deficiencies in the control environment.

.A80 *Audit evidence for elements of the control environment*. Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures, such as corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees management's views on business practices and ethical behavior. The auditor may then determine whether relevant controls have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.

.A81 The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified deficiencies in internal control relevant to the audit, including whether and how such responses have been implemented and whether they have been subsequently evaluated by the internal audit function.

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Component 2: Risk Assessment

Within the control environment, **management is responsible for the assessment of risk for the company**. A risk is anything that endangers the achievement of an objective.

Risk assessment is the process of identifying, analyzing and managing the risks that have the potential to prevent the organization from achieving its objectives. Assessment of risk involves determining the dollar value of assets that are exposed to loss, as well as the probability that a loss will occur.

Therefore, the company's objectives must be established before the risks to them can be assessed. The risk assessment forms the basis for determining how the risks will be managed.

Note: The auditor is concerned only with the risks to the financial statements. This means that the company's risk assessment will encompass many areas that the auditor is not interested in because they do not impact the financial statements.

He auditor needs to assess the company's risk assessment process as it is connected to the financial statements. This includes not only the company's ability to identify risks, but also the assessment of those risks and the decisions that are made regarding them.

If the auditor identifies risks of material misstatement that the client did not identify, the auditor should understand why it was not identified and whether or not it is indicative of larger or systemic failure of the internal control system. Failures like this will impact the auditor's assessment of control risk.

.16 *The entity's risk assessment process*. The auditor should obtain an understanding of whether the entity has a process for

a. identifying business risks relevant to financial reporting objectives,

b. estimating the significance of the risks,

c. assessing the likelihood of their occurrence, and

d. deciding about actions to address those risks.

.17 If the entity has established a risk assessment process (referred to hereafter as the entity's risk assessment process), the auditor should obtain an understanding of it and the results thereof. If the auditor identifies risks of material misstatement that management failed to identify, the auditor should evaluate whether an underlying risk existed that the auditor expects would have been identified by the entity's risk assessment process. If such a risk exists, the auditor should obtain an understanding of why that process failed to identify it and evaluate whether the process is appropriate to its circumstances or determine if a significant deficiency or material weakness exists in internal control regarding the entity's risk assessment process.

.18 If the entity has not established such a process or has an ad hoc process, the auditor should discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor should evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances or determine whether it represents a significant deficiency or material weakness in the entity's internal control.

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Component 3: The Information System

Relevant information must be identified, captured and communicated in a manner that enables people to carry out their responsibilities. This means reports must contain the information that management needs and must be available in a timely manner for management to be able to act on that information.

1) Communication must be **ongoing**, both within and between various levels and activities of the organization. This starts with communication by top management to the rest of the organization.
2) All staff must understand their roles in the internal control system and be able to **communicate significant information upstream**.
3) Reports containing operational, financial and compliance information required for informed decisions – both internally generated and external information – must be available.
4) Supervisors must communicate duties and responsibilities to the employees that report to them, and employees must alert management to potential problems as soon as the arise or become apparent.
5) Some information must be communicated to those outside the organization, such as vendors, and must also be available from external sources.

.19 *The information system, including the related business processes relevant to financial reporting and communication*. The auditor should obtain an understanding of the information system, including the related business processes relevant to financial reporting, including the following areas:

a. The classes of transactions in the entity's operations that are significant to the financial statements.

b. The procedures within both IT and manual systems by which those transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements.

c. The related accounting records supporting information and specific accounts in the financial statements that are used to initiate, authorize, record, process, and report transactions. This includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form.

d. How the information system captures events and conditions, other than transactions, that are significant to the financial statements.

e. The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

f. Controls surrounding journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments.

.20 The auditor should obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including

a. communications between management and those charged with governance and

b. external communications, such as those with regulatory authorities.

Component 4: Control Activities

After the risks have been assessed, controls should be designed to limit the risk. To accomplish this, control activities are implemented. Control activities are the **policies that address the identified risks and procedures that ensure that management directives are carried out**, thus helping ensure that the organization’s objectives will be achieved.

While the company will have control activities in all areas of their business, the auditor is focused on the controls that are connected to financial information and financial reporting.

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Segregation of Duties

Segregation is one specific control activity that you should be aware of as it relates specifically to financial information and reporting. The segregation of duties is a preventative control. This means that the control is designed to prevent any misstatements from occurring.

The duties that need to be segregated are divided among different employees to reduce the risk of errors or inappropriate activities. No individual employee should perform 2 of these duties within the same transaction cycle. This ensures that no single individual is given too much responsibility **so that no employee is in a position to both perpetrate and conceal irregularities**.

The four duties that must be segregated are:

1) Authorizing a transaction.
2) Recording the transaction, preparing source documents, maintaining journals.
3) Keeping physical custody of the related asset – for instance, receiving checks in the mail.
4) The periodic reconciliation of the physical assets to the recorded amounts for those assets.

Note: In a question about an effective or ineffective internal control, keep in mind that these four things must be done by different people.

Examples of segregation of duties:

- One person has custody of cash receipts, while a different person has the authority to authorize account write-offs. (Without segregation, one person could authorize a false write-off while diverting the collection on the account.)
- One person authorizes issuance of purchase orders, while a different person is responsible for recording receipt of inventory. (Without such segregation, one person could issue a purchase order to a fictitious vendor using a rented post office box, then prepare a fictitious receiving record and mail an invoice to the company using a post office box personally rented for that purpose, resulting in the company's paying for something it never ordered or received.)
- One person has authority to adjust accounts receivable, while a different person posts payments on customer accounts. (Without segregation here, one person could divert cash receipts and then falsify the account balances of the customers who paid the cash in order to conceal the diversion.)
- One person is responsible for preparing the bank deposit, while a different person reconciles the checking account. (Without segregation, one person could divert cash receipts and cover the activity by creating "reconciling items" in the account reconciliation.)

Be aware, however, that segregation of duties does not guarantee that fraud will not occur. Two or more employees could collude with one another to commit fraud, covering for one another and, presumably, sharing the proceeds.

Collusion occurs when two or more individuals work together to overcome the internal control system and perpetrate a fraud. When two or more people work together, they are able to get around the segregation of duties that may have been set out.

.21 *Control activities relevant to the audit*. The auditor should obtain an understanding of control activities relevant to the audit, which are those control activities the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. However, the auditor should obtain an understanding of the process of reconciling detailed records to the general ledger for material account balances.

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.22 In understanding the entity's control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from IT.

Note: IT General and Application Controls are looked at later in this section.

Component 5: Monitoring

Finally, **management must monitor** the entire system. Monitoring assesses the quality of the internal control system's performance **over time**. Management must also revisit previously identified problems to make sure they have been corrected.

Monitoring can be done in two ways: (1) through **ongoing monitoring** during normal operations, and (2) **separate evaluations** by management with the assistance of the internal audit function. If monitoring is done regularly during normal operations, it lessens the need for separate evaluations.

Note: Monitoring should be done on a regular basis. An advantage to ongoing monitoring is that if operating reports are used to manage ongoing operations, exceptions to anticipated results will be recognized quickly.

.23 *Monitoring of controls.* The auditor should obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls.

.24 If the entity has an internal audit function, the auditor should obtain an understanding of the nature of the internal audit function's responsibilities how the internal audit function fits in the entity's organizational structure, and the activities performed or to be performed.

.25 The auditor should obtain an understanding of the sources of the information used in the entity's monitoring activities and the basis upon which management considers the information to be sufficiently reliable for the purpose.

Considering Internal Controls in Planning the Audit

The need to understand internal controls is set in AU-C 315.

.13 The auditor should obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

As we can see, the auditor must come to an understanding of the internal control system that is in place with the client. This does not mean that the internal control system must be a good one, or that the auditor will rely on the internal control system, just that the auditor must understand the internal control system.

.26 To provide a basis for designing and performing further audit procedures, the auditor should identify and assess the risks of material misstatement at

a. the financial statement level and

b. the relevant assertion level for classes of transactions, account balances, and disclosures.

The stronger the internal controls are within the client, the less risk there is that the information that comes out of the client's accounting system is incorrect.

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Understanding the Relevant Internal Controls of the Client

In order to plan an effective audit, the auditor should obtain an understanding of the design of relevant internal controls. Additionally, the auditor may also need to determine whether or not the internal controls have been placed in operation. The auditor must document this understanding of the internal control system and include this in the working papers.

The auditor then uses this understanding to plan the audit in regards to determining the nature, timing and extent of the substantive testing.

The understanding process may consist of two different parts.

1) First, the auditor will assess the internal control system "**on paper**." This is simply a review of the system as it is supposed to function. If the auditor feels that the internal control system is well designed on paper, he or she may then decide that to rely on the internal control system of the client. This reliance on the system will reduce the amount of testing that the auditor needs to perform during the audit.

2) Second, before the auditor can rely on the system, he or she also needs to test if the system is actually being placed into operation and functioning as it should be. This testing of the internal control system is called functioning properly "**in reality**."

> **.14** When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel.

The understanding of internal controls must be done and will come from a variety of sources:

- **Prior experience**
- **Inquiries** of management and personnel
- **Inspection** of documents and records
- **Observation**

In the understanding of internal controls, the auditor needs to focus only on relevant internal controls. These are those controls that will have an impact on the financial statements by affecting the assertions made by management. This means that in the understanding and testing of internal controls, the auditor is focusing attention on areas of potential misstatements.

Testing the *design* of Internal Controls

The auditor must determine if the design of the entity's internal controls is such that it will prevent a misstatement from appearing in the financial statements if it is working as designed. This is the process of looking at the internal control system "on paper." In this process the auditor is simply testing to see if the controls would be effective if they are in fact working. Tests of the design of the internal controls of the system normally include:

- **Inquiries** of appropriate personnel,
- **Inspection** of documents and reports, and
- **Observation** of the application of specific controls.

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Testing the *implementation* of Internal Control

It is not enough to simply insure that the entity's internal control policies are properly designed. The auditor also needs to test to make sure that they are being operated correctly. These tests ordinarily include:

- Inquiries of appropriate personnel,
- Inspection of documents and reports,
- Observation of application of specific controls, and
- The **reperformance** of the application of a policy and procedure.

Note: Due to the overlapping nature of the testing of the design and the testing of the effectiveness of internal controls, these two activities may be performed at the same time, and in some cases, by using the same tests. Additionally, the assessment of control risk may be at the same time as the understanding of internal controls is obtained.

.A76 Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include

- inquiring of entity personnel.
- observing the application of specific controls.
- inspecting documents and reports.
- tracing transactions through the information system relevant to financial reporting.

Inquiry alone, however, is not sufficient for such purposes.

After obtaining the understanding of internal control and assessing control risk, if the internal control systems are well designed and operating as they are supposed to be, the auditor may decide to further reduce the assessed level of control risk for some of the financial statement assertions. In order to accomplish this, the auditor should consider not only whether additional evidential matter sufficient to support a further reduction is likely to exist, but also whether tests to obtain that evidence would be efficient. The tests necessary to confirm that internal controls are working properly may be more expensive or time consuming than doing some additional substantive tests.

After evaluating the control risk of an entity, the auditor will draw a conclusion on the assessed level of control risk. To assess control risk, the auditor should:

- Consider the misstatements that could occur,
- Identify policies and procedures relevant to the specific assertions at risk, and
- Perform tests to see if these procedures are working as intended.

Assessing the Risk of Material Misstatement

The assessment of internal controls is done to assist the auditor in assessing the risk of material misstatement. This assessment of risk will impact the design and performance of audit procedures. The stronger the internal control system of the client, the lower the risk of material misstatement. The lower level of risk of material misstatement will mean that the auditor will not be required to do as much testing in order to achieve the required level of audit risk.

This assessment of risks needs to be tied into the assertions and the financial statements since this is what the auditor is concerned with.

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.26 To provide a basis for designing and performing further audit procedures, the auditor should identify and assess the risks of material misstatement at

1. the **financial statement level** and
2. the **relevant assertion level** for classes of transactions, account balances, and disclosures.

.27 For this purpose, the auditor should

1. **identify risks throughout the process of obtaining an understanding of the entity and its environment**, including relevant controls that relate to the risks, by considering the classes of transactions, account balances, and disclosures in the financial statements;
2. **assess** the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
3. **relate the identified risks** to what can go wrong at the relevant assertion level, taking account of relevant controls that the auditor intends to test; and
4. **consider the likelihood of misstatement**, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

The original assessment that the auditor makes about the risk of material misstatement is only an original assessment. As the audit progresses and more information is obtained, the auditor should change the risk of material misstatement as needed based on the new information.

.32 The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances in which the auditor obtains audit evidence from performing further audit procedures or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor should revise the assessment and modify the further planned audit procedures accordingly.

Document the Understanding of the Entity's Internal Control

The understanding of the entity's internal control as well as the conclusion reached must be documented.

.33 The auditor should include in the audit documentation the

a. discussion among the engagement team required by paragraph .11, the significant decisions reached, how and when the discussion occurred, and the audit team members who participated;

b. key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph .12 and each of the internal control components specified in paragraphs .15–.25, the sources of information from which the understanding was obtained, and the risk assessment procedures performed;

c. identified and assessed risks of material misstatement at the financial statement level and at the relevant assertion level, as required by paragraph .26; and

d. risks identified and related controls about which the auditor has obtained an understanding as a result of the requirements in paragraphs .28–.31.

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.A152 The manner in which the requirements of paragraph .33 are documented is for the auditor to determine exercising professional judgment. For example, in audits of smaller entities, the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan. Similarly, the results of the risk assessment may be documented separately, or they may be documented as part of the auditor's documentation of further audit procedures. The form and extent of the documentation is influenced by the nature, size, and complexity of the entity and its internal control; availability of information from the entity; and the audit methodology and technology used in the course of the audit.

.A153 For entities that have uncomplicated businesses and processes relevant to financial reporting, the documentation may be simple and relatively brief. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of the understanding documented by the auditor include those on which the auditor based the assessment of the risks of material misstatement.

There are a number of different ways in which the auditor can document the understanding of internal controls. The most common ways are outlined below.

Questionnaire Approach

Under this approach, a questionnaire is developed by someone experienced in the kind of structure that is being reviewed as a means of documenting the internal control procedures. The questionnaire simply asks a series of yes/no questions about the client's internal control system.

The advantages of the internal control questionnaire are that it is easy to complete and quite comprehensive. Some of the disadvantages are that the questions may be too general, or they may miss specific points unique to certain clients. Another obvious weakness is that some of the questions can simply be answered by a "yes" or "no," which offers no substantial feedback.

Narrative (Memorandum) Approach

Under this methodology, the auditor writes out a description of the prescribed system in his or her own words.

The advantages of the narrative approach are that it is specific to each client, and requires a thorough understanding of the client's internal control structure. The disadvantages are that this approach is very time consuming, and leaves open the possibility that some areas may be overlooked.

Flowchart Approach

This approach uses a graphical scheme to represent a portion of a company's internal control system.

The advantage of the flowchart approach is that it shows the specific steps required and the flow of documents, which makes it harder to overlook steps. The disadvantage is that the process takes longer than using an internal control questionnaire.

IT General and Application Controls

Note: This is listed as a specific Content Topic within Content Group C. The other Content Topics in this Content Group have not been marked specifically in the material.

Controls within a computer system are broken down into two types. They are general controls, which relate to the environment; and application controls, which are controls that are specific to individual applications and are designed to prevent, detect and correct errors and irregularities in transactions during the input, processing and output stages. Both general controls and application controls are essential.

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General controls relate to the general environment within which transaction processing takes place. They are designed to ensure that the company's control environment is stable and well managed. A stable and well-managed control environment strengthens the effectiveness of the company's application controls. General controls include controls over the development, modification and maintenance of computer programs, segregation of duties, data security, administrative controls, and provision for disaster recovery. General controls are broken down into the following categories (each is discussed in greater detail below):

- The **organization and operation** of the computer facilities, including provision for segregation of duties within the data processing function as well as segregation of the data processing function from other operations. The IS activity should have a high enough level in the organization and adequate authority to permit it to meet its objectives. There should be a systems control group to monitor production, keep records, balance input and output, and see that work is completed on schedule.
- **General operating procedures**, including written procedures and manuals. Operating procedures also specify the process to be followed in system development and system changes, in order to provide reasonable assurance that development of, and changes to, computer programs are authorized, tested, and approved prior to the use of the program.
- **Equipment and hardware controls**, including controls installed in computers that can identify incorrect data handling or improper operation of the equipment.
- **Access controls** to equipment and data, such as controls over physical access to the computer system and the data that are adequate to protect the equipment and data files from damage or theft.

Application controls are controls that are specific to individual applications. They are designed to prevent, detect, and correct errors in transactions as they flow through the input, processing, and output stages of work. Thus, they are broken down into these three main categories (each of which is discussed in greater detail below):

1) **Input** controls
2) **Processing** controls
3) **Output** controls

1. Input Controls

Input controls are the controls designed to provide reasonable assurance that data entered into the system has proper authorization, has been converted to machine-sensible form, and has been entered accurately. Input controls can also provide some assurance that data (including data sent over communications lines) has not been lost, suppressed, added or changed in some manner.

Input is the stage where there is the most human involvement and, as a result, the risk of errors is higher than in the processing and output stages. **Most errors in systems are the result of input errors.** If information is not entered correctly, there is no chance that the output will be correct. Processing might be done perfectly, but if the input into the system is inaccurate or incomplete, the output will be useless. Effective input controls are vital.

2. Processing Controls

Processing controls are controls designed to provide reasonable assurance that processing has occurred properly and that no transactions have been lost or incorrectly added. Processing controls prevent or discourage the improper manipulation of data and ensure satisfactory operation of hardware and software.

Processing controls include the physical security of the equipment. At one time, processing controls were limited to the computer room. But with more and more distributed processing taking place, these controls are moving outside the room where the computer equipment is located.

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Access to the computer should be permitted only to people who are authorized to operate the equipment, and operators should be given access only to information they need to set up and operate the equipment.

Processing controls fall into two classifications:

- Processing controls at the time of data access
- Controls involving data manipulation later in the processing

3. Output Controls

Output can consist of account listings, displays, reports, files, invoices, or disbursement checks, to name just a few of the forms output can take. Output controls are used to provide reasonable assurance that input and processing has resulted in valid output. Controls should be in place to make sure that the output is sent to the right people, that it is accurate and complete, it is sent in a timely manner, and that the proper reports are retained for the appropriate time period.

The output of the system is supervised by the **data control group**. Output controls consists of:

- Validating processing results
- Controls over printed output

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C. Unmodified Opinions with an Emphasis-of-Matter or Other-Matter Paragraph (AU-C 706)

There are a number of situations in which the financial statements are properly presented in accordance with GAAP at the balance sheet date, but at the same time there is also a situation or circumstance that the auditor needs to disclose or address in the opinion.

In these situations, the auditor will express an unmodified opinion (because the financial statements are "correct"), but also include an additional explanatory paragraph. This additional paragraph is added **after the opinion paragraph**. There are two types of additional language that may be added. They are called:

1) Emphasis-of-matter paragraphs – this type of additional language relates to the users **understanding of the financial statements**.

2) Other-matter paragraphs – this type of additional language related to the users **understanding of the audit, the auditor's responsibilities or the audit report**.

AU-C 706

.01 This section addresses additional communications in the auditor's report when the auditor considers it necessary to

a. draw users' attention to a matter or matters **presented or disclosed in the financial statements** that are of such importance that they are fundamental to users' understanding of the financial statements (emphasis-of-matter paragraph) or

b. draw users' attention to any matter or matters **other than those presented or disclosed** in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities, or the auditor's report (other-matter paragraph).

Note: When the auditor expects to issue either an emphasis-of-matter or other-matter paragraph, they communicate with those charged with governance about his expected additional paragraph and the proposed wording of this paragraph.

Emphasis of Matter Paragraphs

The emphasis-of-matter paragraph is

AU-C 706

.05 **Emphasis-of-matter paragraph**. A paragraph included in the auditor's report that is required by GAAS, or is included at the auditor's discretion, and that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's professional judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Four situations in which emphasis-of-matter paragraphs are required are listed in other standards. In AU-C 706 there are four additional situations in which an emphasis-of-matter paragraph is required. The list of the eight situations is:

AU-C 706.A14 Exhibit B

- **Subsequent Events** and Subsequently Discovered Facts – AU-C 560
- The Auditor's Consideration of an Entity's Ability to Continue as a **Going Concern** – AU-C 570
- **Consistency** of Financial Statements – AU-C 708

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- Audits of Financial Statements Prepared in Accordance With **Special Purpose Frameworks** – AU-C 800

AU-C 706.A2

- An **uncertainty** relating to the future outcome of **unusually important litigation or regulatory action**
- A **major catastrophe** that has had, or continues to have, a significant effect on the entity's financial position
- Significant transactions with **related parties**
- Unusually important **subsequent events**

The Written Emphasis-of-Matter Paragraph

The emphasis-of-matter paragraph:

- Is placed after the opinion paragraph,
- Has a header "Emphasis of Matter",
- Clearly references the matter being emphasized and identifies where relevant disclosures are located, and
- Indicates that the auditor's opinion is not modified as a result of the emphasis-of-matter paragraph.

AU-C 706

.07 When the auditor includes an emphasis-of-matter paragraph in the auditor's report, the auditor should

a. include it immediately after the opinion paragraph in the auditor's report,

b. use the heading "Emphasis of Matter" or other appropriate heading,

c. include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements, and

d. indicate that the auditor's opinion is not modified with respect to the matter emphasized.

Sample Emphasis-of-Matter Paragraph for an Uncertainty

Emphasis of Matter

As discussed in Note X to the financial statements, the Company is a defendant in a lawsuit [briefly describe the nature of the litigation consistent with the Company's description in the note to the financial statements]. Our opinion is not modified with respect to this matter.

Other-Matter Paragraphs

An other-matter paragraph is

AU-C 706

.05 **Other-matter paragraph**. A paragraph included in the auditor's report that is required by GAAS, or is included at the auditor's discretion, and that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's professional judgment, is relevant to users' understanding of the audit, the auditor's responsibilities, or the auditor's report.

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Some of the situations in which an other-matter paragraph needs to be included are provided within other Sections. Among them are:

AU-C 706.A15 Exhibit C

Subsequent Events and Subsequently Discovered Facts – AU-C 560

Forming an Opinion and Reporting on Financial Statements – AU-C 700, paragraphs .53-.54 and .56-.57

Other Information in Documents Containing Audited Financial Statements – AU-C 720

Supplementary Information in Relation to the Financial Statements as a Whole – AU-C 725

Required Supplementary Information – AU-C 730

Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks – AU-C 800

Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements – AU-C 806

Alert That Restricts the Use of the Auditor's Written Communication – AU-C 905

The Written Other-Matter Paragraph

The added paragraph should include this paragraph immediately after the opinion paragraph. The requirements for emphasis-of-matter should generally be followed, but based on the nature of the other-matter may need to be modified as appropriate for each specific situation.

Sample Other-Matter Paragraph When Auditor an Updated Report on a Prior Period with a Different Opinion than Previously Expressed

Other Matter

In our report dated March 1, 20X1, we expressed an opinion that the 20X0 financial statements did not fairly present the financial position, results of operations, and cash flows of ABC Company in accordance with accounting principles generally accepted in the United States of America because of two departures from such principles: (1) ABC Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) ABC Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 20X0 financial statements to conform with accounting principles generally accepted in the United States of America. Accordingly, our present opinion on the restated 20X0 financial statements, as presented herein, is different from that expressed in our previous report.

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D. Modified Opinions

There are three types of modified opinions: A) Qualified, B) Adverse and C) Disclaimer of an opinion. We will look at the situations in which each of these modified opinions are given and then we will look at the modifications that are made for each situation. We will conclude this topic by providing a number of illustrative opinions taken from AU-C 705. We do not recommend that you memorize all of these opinions, but we strongly encourage you to read them and to become familiar with the language used and the ways in which the reports are different from the standard report.

D1. Qualified Opinion (AU-C 705)

A qualified opinion issued when either the auditor:

1) Was able to obtain sufficient appropriate evidence and concludes that there are **material, but not pervasive, misstatements**, or

2) The auditor is **not able to obtain sufficient appropriate evidence** to make an opinion, but determines that the possible effects of undetected misstatements could be material, but would not be pervasive.

This means that a qualified opinion would be given when there are one or two items on the financial statements that are not materially correct, or one or two areas for which sufficient evidence was not able to be gathered (this is a scope limitation).

Note: The terminology that is associated with a qualified opinion is "material, but not pervasive, misstatements".

AU-C 705.08 The auditor should express a qualified opinion when

a. the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material but not pervasive to the financial statements or

b. the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Further Discussion of Causes of Qualified Opinions

At the most general level, there can be two reasons for issuing a qualified opinion: 1) departure from GAAP (misstatements in the financial statements) or 2) a minor scope limitation.

1) **Departure from GAAP.** When there is a material departure from GAAP (or other applicable financial reporting framework), the auditor must determine whether the departure is pervasive. If it is not pervasive, the auditor may issue a qualified opinion. However, if the departure is pervasive, the auditor should express an adverse opinion. Determining whether a departure from GAAP necessitates a qualified or an adverse opinion is a matter of professional judgment.

   When a qualified opinion is appropriate, the auditor should add a paragraph for each departure to the report before the opinion paragraph. These paragraphs should disclose the effects of the departure on the financial statement, if it is practicable (reasonable) to do so.

   Note: The improper naming of the financial statements is in essence a departure from GAAP. The names Balance Sheet, Income Statement and Statement of Cash Flows imply the use of GAAP. Therefore, if the financial statements use these names, but were not prepared under GAAP, the report should be qualified for this exception.

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2) Other examples of a departure from GAAP include:

- **Inadequate Disclosure** – if the disclosures in the financial statements are not complete, the auditor will need to express either a qualified or an adverse opinion. (An example of inadequate disclosure would be if one of the financial statements were not presented.) The auditor should add a paragraph for each case of nondisclosure describing the item and also presenting the missing information, if it is practicable to do so.

- **Unacceptable Changes in Accounting Methods** – if an accounting change is not justifiable, the auditor should express a qualified or adverse opinion. A qualified opinion includes an additional paragraph before the opinion paragraph outlining the nature of the change and stating that it is not justified.

3) **Scope Limitation.** A scope limitation that could result in a qualified opinion occurs when the auditor is unable to obtain sufficient appropriate audit evidence to form a reasonable basis for an opinion on one aspect the financial statements, but was able to obtain sufficient appropriate evidence to form a reasonable basis for an opinion on the financial statements as a whole. It does not matter what the cause of the limitation was, or whether the client caused it or not. What is important is that there was a limitation. If the limitation was minor or limited in its scope, the auditor may express a qualified opinion.

In this case of a minor limitation, the auditor should add a statement before the opinion that the qualification is **because of the uncertainty that results from the scope limitation** rather than the limitation itself.

Note: If the scope limitation is material or pervasive (relates to many areas of the audit) the auditor may need to issue a disclaimer of opinion. Scope limitations are discussed further in the discussion of Disclaimer of Opinion.

D2. Adverse Opinion (AU-C Section 705)

An adverse opinion states simply that the financial statements **do not present fairly** the financial position of the company. This means that the auditor has concluded that the misstatements are both material and pervasive to the financial statements.

As with a qualified opinion, the auditor needs to disclose all of the reasons that an adverse opinion is given in a paragraph(s) before the audit opinion. Also, as with a qualified opinion, the auditor should include the effect of the errors. The opinion paragraph should make direct reference to the paragraph(s) that are the basis for the opinion.

.09 The auditor should express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Often times, as noted above, the auditor will need to make a decision regarding whether to issue a qualified or adverse opinion. The decision will be made using professional judgment and the impact of the misstatements on the financial statements themselves.

Note: When issuing a qualified or adverse opinion, the auditor should modify the report to state "the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's modified audit opinion." **AU-C 705.27**

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D3. Disclaimer of Opinion (AU-C Section 705)

When the auditor disclaims an opinion, it states that he or she does not have an opinion as to whether or not the financial statements are correct. This occurs when there is either:

1) A **significant scope limitation** (this occurs when the auditor is unable to obtain sufficient appropriate evidence to form a reasonable basis for an opinion on the financial statements as a whole), or

2) When the **auditor is not independent** (Note that this situation should not happen because the auditor should not accept an engagement if they are not independent and that will preclude the issuance of a report).

.10 The auditor should disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

In a disclaimer opinion, the auditor needs to change the opinion paragraph to

1) State that no opinion is given, and

2) Delete the scope paragraph from the report.

Note: If the auditor believes that there are material departures from GAAP, a disclaimer of opinion may not be given. Even if there is a scope limitation the auditor should not disclaim an opinion, but rather give the necessary qualified or adverse opinion as a result of the GAAP departure.

Scope Limitations (AU-C 705.A8-A12)

The inability of the auditor to collect sufficient appropriate evidence may arise from three situations. These situations and examples of each are:

- **Circumstances beyond the control of the entity** – the records have been destroyed.
- **Circumstances relating to the nature or timing of the auditor's work** – the audit timing does not allow the inventory count to be observed or audited financial statements of investees are not able to be obtained.
- **Limitations imposed by management** – management prevents the auditor from observing the inventory count, or from requesting external confirmations.

The specific reason that there is a scope limitation is not important. What is important is that there was a scope limitation and based on the significance of that limitation the auditor will need to issue a qualified or disclaimer opinion.

Note: Limitations imposed by management my give rise to concern about the integrity of management. This may cause the auditor to assess their ability to continue the engagement.

Just because some audit evidence is not able to be obtained or some tests are not able to be performed does not mean that there is a scope limitation. There will be a scope limitation only if the auditor is unable to obtain other evidence or perform other tests that will provide the necessary audit evidence. For example, a confirmation of a receivable is a desired item of audit evidence. However, even if a large customer does not return the confirmation, it does not mean that there is a scope limitation. The auditor may be able to apply other procedures to obtain sufficient appropriate evidence about the receivables balance. If evidence is obtained, even if it was done by using tests that were not the most effective or efficient tests, there is not scope limitation.

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Table of Causes and Reports Issued (AU-C 705.A1)

Nature of the Matter	Material, but not pervasive, effects or possible effects	Pervasive effects or possible effects
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate evidence (Scope limitation)	Qualified opinion	Disclaimer of opinion

The Modified Audit Report (Relevant to Qualified, Adverse and Disclaimer Opinions)

Modified reports differ from the standard report in three significant areas, which we will look at in detail:

1) The Basis for Modification paragraph,
2) Modifications to the Opinion paragraph, and
3) Modifications to the Disclaimer of an Opinion Report.

1) The Basis for Modification Paragraph

Whenever a modified opinion is expressed, the auditor should include one paragraph for each of the reasons that caused the modified opinion. There should be separate paragraphs for each item, which should be placed **before the opinion paragraph** because the opinion itself is based on the information outlined in these paragraphs. This section of the report should be titled "Basis for Qualified Opinion".

There are a number of different reasons for a modified opinion to be given and each has its own requirements in respect to the basis for modification of opinion paragraph. The different reasons and treatment of each in the basis for modification paragraph is provided in the table below.

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Cause of Modification	Disclosure in Basis for Modification Paragraph
Material Misstatement that relates to specific amounts in the financial statements	**AU-C 705.18** The auditor should include in a description and quantification of the financial effects of the misstatement, unless impracticable (see discussion following this table). If it is not practicable to quantify the financial effects, the auditor should so state in the basis for modification paragraph.
Material misstatement that relates to narrative disclosure	**AU-C 705.19** The auditor should include an explanation of how the disclosures are misstated.
Material misstatement that relates to omission of information	**AU-C 705.20** The auditor should a. discuss the omission of such information with those charged with governance; b. describe in the basis for modification paragraph the nature of the omitted information; and c. include the omitted information, provided that it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.
Inability to obtain sufficient appropriate audit evidence	**AU-C 705.21** The auditor should include the reasons for that inability.
Other items when adverse or disclaimer of opinion	**AU-C 705.22** The auditor should a. describe in the basis for modification paragraph any other matters of which the auditor is aware that would have required a modification to the opinion and the effects thereof and b. consider the need to describe in an emphasis-of-matter or other matter paragraph(s) any other matters of which the auditor is aware that would have resulted in additional communications in the auditor's report on the financial statements that are not modifications of the auditor's opinion.

"If Practicable" and Impracticable

These terms are used when discussing the disclosure of information connected to qualified and adverse opinions. It is important that you know what this term means and it is described in AU-C 705.

AU-C 705

.A24 Practicable means that the information is reasonably obtainable from management's accounts and records and that providing the information in the report does not require the auditor to assume the position of a preparer of financial information. For example, the auditor would not be expected to prepare a basic financial statement or segment information and include it in the auditor's report when management omits such information.

.A25 Disclosing the omitted information in the basis for modification paragraph wouldn't be practicable if:

a. the information has not been prepared by management or the information is otherwise not readily available to the auditor or

b. in the auditor's professional judgment, the information would be unduly voluminous in relation to the auditor's report.

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2) Modifications to the Opinion Paragraph

When a modified opinion is given, changes will need to be made to the Opinion paragraph. The paragraph needs to be titled properly as either "Qualified Opinion", "Adverse Opinion" or Disclaimer of Opinion".

Additionally, for modified opinions, the opinion paragraph itself needs to be modified. The changes to the opinion paragraph are given in the following table.

Type of Opinion	Changes to the Opinion Paragraph
Qualified	**AU-C 705.24** The auditor should state in the opinion paragraph that, in the auditor's opinion, except for the effects of the matter(s) described in the basis for qualified opinion paragraph, the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor should use the corresponding phrase "except for the possible effects of the matter(s) . . ." for the modified opinion.
Adverse	**AU-C 705.25** The auditor should state in the opinion paragraph that, in the auditor's opinion, because of the significance of the matter(s) described in the basis for adverse opinion paragraph, the financial statements are not presented fairly in accordance with the applicable financial reporting framework.
Disclaimer of Opinion	**AU-C 705.26** The auditor should state in the opinion paragraph that a. because of the significance of the matter(s) described in the basis for disclaimer of opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion and b. accordingly, the auditor does not express an opinion on the financial statements.

3) Modifications to the Disclaimer of an Opinion Report

When a disclaimer of an opinion report is given, the auditor needs to modify the introductory paragraph and the description of the scope.

AU-C 705

.28 The auditor should amend the introductory paragraph of the auditor's report to state that the auditor was engaged to audit the financial statements.

The auditor should also amend the description of the auditor's responsibility and the description of the scope of the audit to state only the following: "Our responsibility is to express an opinion on the financial statements based on conducting the audit in accordance with auditing standards generally accepted in the United States of America. Because of the matter(s) described in the basis for disclaimer of opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion."

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Sample Modified Opinions

We are presenting five sample reports from the Exhibits of AU-C 705. They are:

1) Qualified Opinion Due to a Material Misstatement of the Financial Statements
2) Qualified Opinion for Inadequate Disclosure
3) Adverse Opinion Due to a Material Misstatement of the Financial Statements
4) Qualified Opinion Due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence
5) Disclaimer of Opinion Due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence About a Single Element of the Financial Statements

Note: In all of the samples below, instead of repeating large amounts of text that are the same as the unmodified opinion, we have simply stated that the relevant paragraph is the same as the unmodified opinion.

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Sample 1) Qualified Opinion Due to a Material Misstatement of the Financial Statements

Circumstances include the following:

• Audit of a complete set of general purpose financial statements (comparative) prepared in accordance with accounting principles generally accepted in the United States of America.

• Inventories are misstated. The misstatement is deemed to be material but not pervasive to the financial statements. Accordingly, the auditor's report contains a qualified opinion.

Independent Auditor's Report

[Appropriate Addressee]

Report on the Financial Statements

Same as unmodified opinion.

Management's Responsibility for the Financial Statements

Same as unmodified opinion.

Auditor's Responsibility

Same as unmodified opinion.

Basis for Qualified Opinion

The Company has stated inventories at cost in the accompanying balance sheets. Accounting principles generally accepted in the United States of America require inventories to be stated at the lower of cost or market. If the Company stated inventories at the lower of cost or market, a write down of $XXX and $XXX would have been required as of December 31, 20X1 and 20X0, respectively. Accordingly, cost of sales would have been increased by $XXX and $XXX, and net income, income taxes, and stockholders' equity would have been reduced by $XXX, $XXX, and $XXX, and $XXX, $XXX, and $XXX, as of and for the years ended December 31, 20X1 and 20X0, respectively.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1 and 20X0, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

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Sample 2) Qualified Opinion for Inadequate Disclosure

Circumstances include the following:

- Audit of a complete set of general purpose financial statements (comparative) prepared in accordance with accounting principles generally accepted in the United States of America.
- The financial statements have inadequate disclosures. The auditor has concluded that (a) it is not practicable to present the required information and (b) the effects are such that an adverse opinion is not appropriate. Accordingly, the auditor's report contains a qualified opinion.

Independent Auditor's Report

[Appropriate Addressee]

Report on the Financial Statements

Same as unmodified opinion.

Management's Responsibility for the Financial Statements

Same as unmodified opinion.

Auditor's Responsibility

Same as unmodified opinion.

Basis for Qualified Opinion

The Company's financial statements do not disclose *[describe the nature of the omitted information that is not practicable to present in the auditor's report]*. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.

Qualified Opinion

In our opinion, except for the omission of the information described in the Basis for Qualified Opinion paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1 and 20X0, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

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Sample 3) Adverse Opinion Due to a Material Misstatement of the Financial Statements

Circumstances include the following:

- Audit of a complete set of consolidated general purpose financial statements (single year) prepared in accordance with accounting principles generally accepted in the United States of America.
- The financial statements are materially misstated due to the nonconsolidation of a subsidiary. The material misstatement is deemed to be pervasive to the financial statements. Accordingly, the auditor's report contains an adverse opinion. The effects of the misstatement on the financial statements have not been determined because it was not practicable to do so.

Independent Auditor's Report

[Appropriate Addressee]

Report on the Consolidated Financial Statements

Same as unmodified opinion.

Management's Responsibility for the Financial Statements

Same as unmodified opinion.

Auditor's Responsibility

Same as unmodified opinion.

Basis for Adverse Opinion

As described in Note X, the Company has not consolidated the financial statements of subsidiary XYZ Company that it acquired during 20X1 because it has not yet been able to ascertain the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis by the Company. Under accounting principles generally accepted in the United States of America, the subsidiary should have been consolidated because it is controlled by the Company. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the consolidated financial statements referred to above do not present fairly the financial position of ABC Company and its subsidiaries as of December 31, 20X1, or the results of their operations or their cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

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Sample 4) Qualified Opinion Due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence

Circumstances include the following:

• Audit of a complete set of general purpose financial statements (single year) prepared in accordance with accounting principles generally accepted in the United States of America.

• The auditor was unable to obtain sufficient appropriate audit evidence regarding an investment in a foreign affiliate. The possible effects of the inability to obtain sufficient appropriate audit evidence are deemed to be material but not pervasive to the financial statements. Accordingly, the auditor's report contains a qualified opinion.

Independent Auditor's Report

[Appropriate Addressee]

Report on the Financial Statements

Same as unmodified opinion.

Management's Responsibility for the Financial Statements

Same as unmodified opinion.

Auditor's Responsibility

Same as unmodified opinion.

Basis for Qualified Opinion

ABC Company's investment in XYZ Company, a foreign affiliate acquired during the year and accounted for under the equity method, is carried at $XXX on the balance sheet at December 31, 20X1, and ABC Company's share of XYZ Company's net income of $XXX is included in ABC Company's net income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC Company's investment in XYZ Company as of December 31, 20X1 and ABC Company's share of XYZ Company's net income for the year then ended because we were denied access to the financial information, management, and the auditors of XYZ Company. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

Qualified Opinion

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

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Sample 5) Disclaimer of Opinion Due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence About a Single Element of the Financial Statements

Circumstances include the following:

• Audit of a complete set of general purpose financial statements (single year) prepared in accordance with accounting principles generally accepted in the United States of America.

• The auditor was unable to obtain sufficient appropriate audit evidence about a single element of the financial statements. That is, the auditor was unable to obtain audit evidence about the financial information of a joint venture investment accounted for under the proportionate consolidation approach. The investment represents over 90 percent of the Company's net assets. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the financial statements. Accordingly, the auditor's report contains a disclaimer of opinion.

• The auditor concluded that it was unnecessary to include in the auditor's report specific amounts for the Company's proportional share of the assets, liabilities, income, and expenses of the joint venture investment because the investment represents over 90 percent of the Company's net assets, and that fact is disclosed in the auditor's report.

Independent Auditor's Report

[Appropriate Addressee]

Report on the Financial Statements

We were engaged to audit the accompanying financial statements of ABC Company, which comprise the balance sheet as of December 31, 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Same as unmodified opinion.

Auditor's Responsibility

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

Basis for Disclaimer of Opinion

The Company's investment in XYZ Company, a joint venture, is carried at $XXX on the Company's balance sheet, which represents over 90 percent of the Company's net assets as of December 31, 20X1. We were not allowed access to the management and the auditors of XYZ Company. As a result, we were unable to determine whether any adjustments were necessary relating to the Company's proportional share of XYZ Company's assets that it controls jointly, its proportional share of XYZ Company's liabilities for which it is jointly responsible, its proportional share of XYZ Company's income and expenses for the year, and the elements making up the statements of changes in stockholders' equity and cash flows.

Disclaimer of Opinion

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

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

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