

# Center for Plain English Accounting

## AICPA's National A&A Resource Center

### **Avoiding Compliance Issues with Auditor Reports**

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High quality audit reports are critical to serving the public interest, as discussed in recently issued Statement on Auditing Standards (SAS) 146, *Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (AU-C 220.06). AU-C 700, *Forming an Opinion and Reporting on Financial Statements*, is the foundational AU-C section that addresses the auditor's responsibility to form an opinion on the financial statements and prescribes the form and content of the auditor's report when issuing an unmodified "clean" opinion. AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*, addresses the form and content of the report when the auditor concludes that a clean auditor's opinion is not appropriate (qualified, adverse, or disclaimer of opinion).

**Practice Note:** SAS 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*, significantly amended AU-C 700 and AU-C 705 and is effective for periods ended on or after December 15, 2021. For more information about SAS 134, see our reports:

- [A Nuanced Look at SAS 134 Reporting Requirements](#)
- [More Than Just the Audit Opinion: SAS 134 Significant Changes Unrelated to the Auditor's Report](#)

### Can You Answer This Quiz Question Correctly?

The author has presented auditing seminars around the country for over 40 years. One of the informal “quizzes” he has given to his seminar attendees periodically is as follows:

A standard auditor report includes the statement that “We conducted our audit in accordance with auditing standards generally accepted in the United States of America (GAAS).” GAAS take the form of AICPA Statements on Auditing Standards (SASs), codified into Professional AU-C sections. Which auditing standards is the auditor claiming to have been followed in a standard auditor report? Those that are:

- a. Relevant
- b. Material
- c. Relevant and material
- d. Solely based on auditor judgment
- e. Unspecified – these words are required to appear in the report
- f. I’m sorry, I have no idea

The correct answer is “a,” as indicated in the citation from AU-C 200 below. The author’s consistent experience over the years has been that, in a room full of 30 experienced auditors, only one or two, if any, will answer correctly.

AU-C 200.22 indicates “The auditor should not represent compliance with GAAS in the auditor’s report unless the auditor has complied with the requirements of this section and all other AU-C sections relevant to the audit.”

The author has read numerous auditor’s reports in recent years, issued by firms of all sizes, all of which were signed and dated, representing to have conducted audit(s) in accordance with GAAS. Those readings reveal numerous compliance issues with the language used in auditor reports. Furthermore, our continuing review of Peer Review Matters for Further Consideration (MFCs) indicates that AU-C 700 remains a top 10 AU-C section when it comes to peer review MFCs. Similarly, AU-C 705 is frequently cited in MFCs. Based on the experiences of the author and on our review of 2021 Peer Review MFCs, we address the following key causes of compliance issues with auditor reports (Note that SAS 134 was generally not effective for the periods covered by the 2021 Peer Review MFCs.):

- **Failure to include required content in the auditor’s report** as specified in AU-C 700, and other relevant AU-C sections, including report content sequencing.

- **Failure to express an appropriate opinion** - Per AU-C 700.04, opinions are either unmodified, or modified (qualified, adverse, or disclaimer). AU-C 705 provides the standards applicable to modified opinions.
- **Errors and false statements** regarding the audit scope, accounting principles, audit findings, or any other statement of substance.

As we highlight the causes of compliance issues with audit reports, it's important to remember that an auditor's opinion involves professional judgment, which can vary among different professionals. AU-C 200.A28 contains a very important observation in this regard:

The distinguishing feature of professional judgment expected of an auditor is that such judgment is exercised based on competencies necessary to achieve reasonable judgments, developed by the auditor through relevant training, knowledge, and experience.

#### Failure to Include Required Report Content

A major reason behind compliance issues with audit reports is the failure to include all the necessary elements in the audit report. Auditors are reminded to follow the requirements in AU-C 700.21 through AU-C 700.43, which prescribes the content of the audit report.

The author has observed numerous instances of report content deficiencies, including the examples below.

#### **Author Observation**

Despite basing the opinion on "our audit and the report of other auditors," the auditor failed to indicate anywhere in the audit report what was audited by the other auditors, whose report did not accompany theirs.



#### **Author Observation**

Auditors of numerous local government financial statements over multiple years failed to properly identify the individual opinion units in the financial statements subject to the respective audits.



### Author Observation

An auditor reporting on a June 30, 2021 set of GAAP financial statements under SAS No. 134 (early application) failed to opine on the entity's change in financial position, include a Basis for Opinion section, and report on Other Information presented with the financial statements.



Peer Review MFCs recorded in 2021 that are representative of failures to include required report content are presented below.

### Example Matter for Further Consideration

**Reviewer Description of Matter:**

The firm's audit report on its only audit engagement was outdated and did not incorporate the requirements of the clarified auditing standards for reporting.

**Reviewed Firm Comments:**

Auditor's report template has been updated for the clarified auditing standards. If needed, the firm will reissue the audit opinion with the updated template, otherwise clarified auditing standards will be closely monitored and we will ensure to use latest updated template in future engagements.



### Example Matter for Further Consideration

**Reviewer Description of Matter:**

The Auditor report was missing heading and a paragraph for management responsibility, headers for Auditors Responsibility and the Opinion heading was missing.

**Reviewed Firm Comments:**

Matter was an oversight - all other audit engagements include proper auditor's report wording.



### Example Matter for Further Consideration

**Reviewer Description of Matter:**

The audit report did not include the appropriate reference to the predecessor auditor in an other-matter paragraph as required by AU-C 700.57.

**Reviewed Firm Comments:**

This was an isolated incident however we agree with the comment for the specific audit selected for review. We have since self-reviewed all other audits completed within the peer review window to ensure other-matter paragraphs referencing predecessor auditors were included where appropriate, noting no other issues. Several other newly acquired audits were also selected for peer review and were reported properly.



### Failure to Express an Appropriate Opinion

The author's experiences and a review of 2021 Peer Review MFCs find that another frequent cause underlying compliance issues with audit reports is a failure to modify a report and express an appropriate opinion. Auditors are reminded to follow the requirements in AU-C 705 addressing circumstances in which a modification to the audit opinion is required in determining the type of modification.

The author has seen a number of failures to express an appropriate opinion, including the following observations.

### Author Observation

An auditor failed to modify the opinion for material misstatements in the comparative Statements of Activities of a not-for-profit (NFP) foundation that under-reported fundraising and general and administrative costs resulting in part from inter-mixing natural and functional expenses in the total operating expense amount. Program expenses were presented outside of operating expenses. (See our CPEA April, 2021 [report](#) entitled *Not-for-Profit Functional Expense Reporting – Common Area of Noncompliance*). Most of these errors were corrected in the comparative presentation in the following year's comparative financial statements, but with no acknowledgment of the correction of these errors. The same auditor failed to modify their opinion in that following year's audit.



### Author Observation

An audit report was not modified on a set of NFP comparative financial statements where two-thirds of its net assets were improperly identified as donor restricted in perpetuity vs. not in perpetuity. Detail note totals did not agree with the amounts on the Statement of Financial Position. Neither the financial statements nor the auditor's report were recalled and reissued. The subsequent year's auditor's report was not modified for the correction of this error.



### Author Observation

An auditor failed to modify his/her opinion on a set of financial statements prepared for a special purpose government engaged only in business-type activities for numerous material GAAP departures (see GASB 34, *Basic Financial Statements – And Management's Discussion and Analysis – For State and Local Governments*), including

- Balance sheet not in “classified” format
- Statement of revenues and expenses did not distinguish between operating and nonoperating items
- Reporting capital assets previously disposed
- Failure to report a very significant capital asset received previously from another government
- Several note disclosures needed for fair presentation



MFCs that are representative of failures to express an appropriate opinion are presented below.

### Example Matter for Further Consideration

**Reviewer Description of Matter:**

The independent auditor's report does not note the financial statements departures from professional standards as to the statement(s) formats and disclosures generally inconsistent with current standards (expenses not presented / disclosed by function / no disclosure (boiler plate) as to revenue FASB 606 / no liquidity note disclosure / lack of an accounting policy disclosure as to basis of presentation / statement of cash flow non-compliance as to restricted cash). The report should note the departure(s).

**Reviewed Firm Comments:**

I agree with the findings and will make sure future financial statements contain the appropriate footnotes and statement formats.



### Example Matter for Further Consideration

**Reviewer Description of Matter:**

The firm's quality control policies and procedures for engagement performance were not followed in that some required disclosures were not included in the notes to the audited financials, required supplementary information was not included in the government audit, revisions to the audit reports did not include proper modifications related to supplementary information.

**Reviewed Firm Comments:**

The firm has since made improvements in overseeing all attest engagements and will continue to monitor auditing requirements going forward. In addition, the firm has made the decision to no longer perform any engagements for governmental entities in order to focus on other lines of business.



### Errors and False Statements in the Audit Report

Another major cause underlying compliance issues with audit reports is the presence of errors and false statements. The author's experience finds a variety of errors and false statements that are made in audit reports and examples are presented below. Two areas worth highlighting are report dating deficiencies and a failure to reference the statement of functional expenses.

### *Report Dating Deficiencies*

Of particular note, errors often relate to report dating. Auditors are reminded that AU-C 700.43 indicates that the auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence of the following:

- All the statements and disclosures that the financial statements comprise have been prepared
- Management has asserted that it has taken responsibility for those financial statements.

Related to the dating of the management representation letter, AU-C 580, *Written Representations*, and more specifically, AU-C 580.20 indicates that the date of the written representations should be as of the date of the auditor's report on the financial statements.

### *Failure to Reference the Statement of Functional Expenses*

FASB Accounting Standards Codification (FASB ASC) 958-205, *Not-for-Profit Entities: Presentation of Financial Statements*, specifically 958-205-45-6, indicates that all NFPs should report information about all expenses in one location—on the face of the statement of activities, as a schedule in the notes to financial statements, or in a separate financial statement. Our review of 2021 MFCs reveal that a cause of compliance issues with audit reports is a failure to reference the statement of functional expenses when such a statement is included in the financial statements. Example MFCs are presented below.

Auditors are reminded to maintain an effective quality management system that enables the issuance of audit reports that are appropriate in the circumstances. The wording of audit reports should be reviewed to ensure that the reports accurately reflect the facts and circumstances of the engagement.

Examples of errors and false statements in audit reports the author has recently observed are below.

### Author Observation

An auditor had only audited the current year financial statements but stated in the auditor's report that the auditor had audited both years. (The auditor also failed to mention that the NPO was a component unit of a government and that the basis of accounting used was inappropriate for the government's GAAP basis financial statements).



### Author Observation

On a single audit engagement, an auditor's yellow book report indicated there were reportable findings, but neither that report nor the accompanying Schedule of Findings and Questioned Costs reported any. That same auditor's Single Audit compliance report indicated that the auditee's major federal programs were identified in the Schedule of Findings and Questioned Costs. They were not. Neither of these auditor's reports were subsequently recalled and corrected.



### Author Observation

An auditor reporting on a City's financial statements under SAS No. 134 in the "going concern" paragraph referred to both FASB alternatives for defining the "reasonable period of time" management is to use for their evaluation of "substantial doubt" rather than the appropriate GASB definition (see SAS No. 132)



MFCs that are representative of this area include the following:

### Example Matter for Further Consideration

**Reviewer Description of Matter:**

The date of the audit report was prior to all reviews being completed and signed off. Based on expansion to other engagements this was not considered a systemic issue.

**Reviewed Firm Comments:**

The client returned the approval for the financial statements & signed rep letter prior to the completion of the EQCR. The financial statements were not released until the EQCR was completed. The EQCR did not change the report so an updated rep letter was not deemed necessary, therefore, the report was dated the same date as the rep letter. In the future we will ensure that reports are not dated until after all reviews are completed and documented.



### Example Matter for Further Consideration

**Reviewer Description of Matter:**

For both a review engagement and an audit of a not-for-profit entity, the date that management signed the representation letter was not the same date as the accountant's/auditor's report.

**Reviewed Firm Comments:**

We will ensure that the date on management representation letters agrees with the corresponding accountant's /auditor's reports.



### Example Matter for Further Consideration

**Reviewer Description of Matter:**

On the audit engagement reviewed, there was a significant lapse between the report date and the date the audit report was released. The firm owner advised that the report was dated as of the last day of fieldwork, but he did not review the documentation until a few days before the release date. Professional standards require that the audit report not be dated until all procedures, including review by the engagement partner, have been completed.

**Reviewed Firm Comments:**

Relied on outdated standard.



### Example Matter for Further Consideration

**Reviewer Description of Matter:**

The auditor's report did not reference the statement of functional expenses.

**Reviewed Firm Comments:**

I missed that completely. It is part of the text. I was reviewing my own work and did not see it. Going forward, staff is preparing those items so I can review and make sure the audit reports go out completely and correct.



### Example Matter for Further Consideration

**Reviewer Description of Matter:**

The auditee failed to properly implement ASU 2016-14 and the firm failed to detect it. Therefore, outdated terms related to net assets were used and disclosures were missed. In addition, the firm did not list the statement of functional expenses in the first paragraph of the independent auditor's report.

**Reviewed Firm Comments:**

We have reviewed the guidance noted by the peer reviewer and have made steps to implement these requirements. In addition, we will search for additional CPE with the focus on NFP accounting and financial reporting. In regards to the liquidity disclosure, we believed that the financial statement presentation and organization satisfied this requirement. But, upon review of the guidance noted, we now believe the note disclosure is necessary and will add the disclosure to our disclosure checklist as a necessity.



### Example Matter for Further Consideration

**Reviewer Description of Matter:**

The independent auditor's report stated the financial statements were reported in accordance with GAAP when they were a special purpose financial statement in accordance with other reporting provisions. In addition, a restriction on use section was omitted.

**Reviewed Firm Comments:**

The auditor report was updated but failed to remove GAAP references. We will be more diligent in our review process to make sure updates are made correctly. We were following the Texas Department of Insurance template that appears to not be up to date.



### Summary

Auditors should maintain an effective quality management system to safeguard that appropriate audit reports (unmodified or modified) are issued, comply with relevant auditing standards, and are free from errors and false statements.

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