

4.5: The Purpose and Content of an Independent Auditor's Report

Learning Objectives

At the end of this section, students should be able to meet the following objectives:

1. Describe the purpose of the independent auditor's report.
2. Identify the intended beneficiaries of an independent auditor's report.
3. Discuss the contents of the introductory, scope, and opinion paragraphs in an independent auditor's report.
4. List problems that might impact the contents of an independent auditor's report.
5. Indicate the method used by decision makers to determine whether an independent auditor has been unable to issue an unqualified opinion.

Question: At the conclusion of an audit, a report is issued that will be attached to the financial statements for all to read. While the format of this report is specified by the PCAOB (approved by the SEC) and some of the words will sound the same for each company- the PCAOB has recently approved changes to the report that will make them more uniquely tailored for each company. What information is conveyed by an independent auditor and what should a reader look for when studying an audit report?

Answer: The audit report accompanying the 2022 financial statements for Apple, Inc. is found below.

To the Shareholders and the Board of Directors of Apple Inc.

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Apple Inc. as of September 24, 2022 and September 25, 2021, the related consolidated statements of operations, comprehensive income, shareholders' equity and cash flows for each of the three years in the period ended September 24, 2022, and the related notes (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of Apple Inc. at September 24, 2022 and September 25, 2021, and the results of its operations and its cash flows for each of the three years in the period ended September 24, 2022, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (the “PCAOB”), Apple Inc.’s internal control over financial reporting as of September 24, 2022, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) and our report dated October 27, 2022 expressed an unqualified opinion thereon.

Basis for Opinion

These financial statements are the responsibility of Apple Inc.'s management. Our responsibility is to express an opinion on Apple Inc.'s financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to Apple Inc. in accordance with the U.S. federal securities laws and the applicable rules and regulations of the U.S. Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matter

The critical audit matter communicated below is a matter arising from the current period audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of the critical audit matter does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matter below, providing a separate opinion on the critical audit matter or on the account or disclosure to which it relates.

[illegible][illegible]

/s/ Ernst & Young LLP

We have served as Apple Inc.'s auditor since 2009.

San Jose, California

October 27, 2022

To understand the role of the independent audit within the financial reporting process, a considerable amount of information should be noted in the report found above.

1. The report is addressed to the board of directors (elected by the shareholders) and the shareholders. An audit is not performed for the direct benefit of the reporting company or its management but rather for any person or group studying the financial statements for decision-making purposes. The salutation stresses that those external users (rather than the company itself) are the primary

beneficiaries of the work carried out by the independent auditor.

Interestingly, independent auditors are paid by the reporting company. The concern is raised periodically as to whether an auditor can remain properly independent of the organization that is providing payment for the services rendered. However, audit examinations are quite expensive and no better method of remuneration has yet been devised.

2. To avoid any potential misunderstanding, the first (opinion) section identifies the specific financial statements to which the report relates. Note that reference is made to two audits – an audit of the financial statements (CPA's do not audit the records but rather the financial statements – accounting records provide evidence) and an audit of internal controls. For both, the auditors express an opinion that the statements and internal controls meet specified standards.
3. The second (basis for opinion) section provides considerable information about the audit work. In addition, both the responsibility of the management for those financial statements and the responsibility of the independent auditor for providing an opinion on those statements are clearly delineated. The statements are examined by the auditor. The statements are not created by the auditor; that is a job for management. Note the key sentence at the beginning of the second paragraph. It explains the purpose of the audit by referring to the standards created by the PCAOB. It further explains that the audit is planned to obtain “reasonable assurance” not absolute assurance.

The remainder of the second paragraph describes in general terms the steps taken by the auditor:

- Examine evidence on a test basis to support reported amounts
 - Assess the accounting principles that were applied
 - Assess significant estimations used in creating the statements
 - Evaluate overall presentation
4. The third (CAM) section describes critical audit matters. According to the PCAOB, a critical audit matter is “any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment.” This section will be unique for each company and is designed to give greater clarity to difficult issues that arose during the audit. This does not mean there are material misstatements but rather that this is an area where there was a higher than normal risk of misstatement.
 5. The fourth section describes how the auditor responded to the critical audit matter(s) described above. What extra work or specialized tasks did they undertake to respond to the additional risk identified above so that we can still have confidence that there are no material misstatements.
 6. The auditor signs the report and must include the length of time for which they have been the auditor (some believe being a long time auditor makes it less likely that the auditor will miss material misstatements).

Question: The audit report presented here for Apple, Inc. is an clean opinion. The independent auditor is providing reasonable assurance to decision makers that the company's financial statements are presented fairly, in all material respects, in conformity with U.S. GAAP. What can cause an independent auditor to issue an audit report with less than an clean opinion and how is that report physically different?

Answer: An independent auditor renders an opinion that is not clean in two general situations:

- The auditor was not able to obtain sufficient evidence during the audit to justify a clean opinion. Perhaps the amount reported for a building or a liability could simply not be substantiated to the auditor's satisfaction. The balance might well be fairly presented according to U.S. GAAP but evidence was not available to allow the auditor to make that assertion with reasonable assurance.
- The auditor discovers the existence of a material misstatement in the financial statements, a balance or disclosure that does not conform to U.S. GAAP. Because of the potential damage to the credibility of the financial statements, a reporting company will usually make any adjustments necessary to eliminate such misstatements. If not, though, the auditor must clearly warn readers of such problems.

The physical changes made in the report depend on the type of problem that is involved and its magnitude. The opinion paragraph will altered to reflect the auditor's concern that they cannot express an opinion that GAAP has been followed. Furthermore, a new paragraph is added after the opinion paragraphs to describe the auditor's areas of concern in some detail. Decision makers often scan the audit report solely to see if such a paragraph is contained. If present, a careful reading of its contents (as well as related changes found in the wording of the opinion paragraph) should be made to determine the possible ramifications. Whether evidence was lacking or a material misstatement was uncovered, the auditor is providing a warning for the reader. The presence of an added paragraph always draws attention.

Key Takeaway

Upon completion of an audit, the independent auditor's report is attached to the financial statements. It is provided for the benefit of external decision makers. The financial statements are identified and the second (basis for opinion) section provides an explanation of the audit process. If no problems are encountered, the report is said to be clean and the opinion paragraph provides reasonable assurance to readers that the financial statements are presented fairly because no material misstatements are present according to U.S. GAAP. A qualification arises if the auditor is not able to obtain a satisfactory amount of evidence or if a material misstatement is found. Information about any such problem is then inserted into the audit report between the opinion section and the basis for opinion paragraph.

Talking with a Real Investing Pro (Continued)

Following is a continuation of our interview with Kevin G. Burns.

Question: An independent audit is extremely expensive for any reporting company. As an investor, is the benefit gained from seeing the independent auditor's report attached to a set of financial statements actually worth the cost that must be incurred by the company?

Kevin Burns: I think the answer to this question is fairly obvious given the recent scandals, especially in the hedge fund world. An independent audit is absolutely critical for a corporation no matter what the expense. It is an exciting time to be in the accounting profession as investors are demanding additional transparency and independent oversight. Market confidence will be even more critical than usual for any business that wants to obtain money by issuing its equity shares and debt instruments. An internal audit would be perceived as self serving and untrustworthy and perception is 90 percent of reality, especially in today's cynical environment.