

Levels of Accountant-Prepared Financial Statements and Sample Cover Letters

Accountant-Prepared Statements Exercise

Individually or in small groups, review the following pages and complete the charts below.

I. Unaudited statements (example cover letters on pages 43-46)

Type	Features	Reliability
	Less in scope than an audit and provides only limited assurance that the statement is prepared in accordance with GAAP. Some are expanded to include specially-requested tests of receivables and/or inventory	May be reliable for some analysis situations, but not as reliable as an audit. Popular service due to lower cost vs. audit
	Contains few or no disclosures of accounting methods, except if any departures from GAAP observed. Usually excludes footnotes and statement of cash flows	Much less reliability of data because of lack of independent testing and verification
	Very similar to a compilation, but usually no report from CPA and no notation of non-independence	
	Prepared internally by business employee(s), so key issue is accounting experience and knowledge of the person responsible , plus knowing the method of accounting (cash or accrual) used, plus revenue recognition practices, etc. (see page 10)	Least assurance due to lack of independent testing and verification, plus possible inconsistencies and departures from GAAP
	Revenues and expenses recognized using IRS rules, and frequently on cash basis	Similar to company prepared, even if tax return prepared by accountant

Potential answers: [accountant] prepared, company prepared, compiled, income tax basis, reviewed

II. Audited statements (example cover letters on pages 46-52)

Type	Features	Reliability
	Without any qualifications, the data fairly represents the financial condition of business.	Most reliable
	Contains an exception or qualification described as “except for” when there is some departure from GGAP or when the audit scope was limited	Depends on the nature of qualification, but generally very reliable
	Departures from GAAP are too material to allow even a qualified opinion	Generally a red flag in terms of reliability and creditworthiness
	Opinion expressed, but auditor doubts that business can continue to operate	A definite red flag that could have significant bearing on creditworthiness
	Auditor cannot express an opinion due to lack of information and/or limited audit scope	Depends on reasons for lack of complete work by accountant

Potential answers/opinions: adverse, disclaimer, going concern, qualified, unqualified

- III. The financial statements being audited are the responsibility of management. Here's an interesting *letter to the editor* of The Wall Street Journal, March 21, 2023 shortly after the Silicon Valley Bank fiasco:

Is SVB Auditor KPMG at Fault?

Auditors don't issue any company "a clean bill of health." They report whether the financial statements fairly present in all material respects the financial condition of a company at a point in time. Auditors don't report whether management is doing a good job, whether the company's securities are good investments, whether customers will stick around or whether the company will be profitable in the future. Those are all questions for analysts, investors [bankers] and regulators. *BRYAN H. JONES, C.P.A., Dallas*

- IV. When you return to the bank, In the space below enter your bank's policy requirements for business financial statements based on total credit exposure (fill in from your bank's policy; usually does not apply to single-asset CRE holding companies, farms and other specialized firms)

- V. Reasons (other than bank policy) customer should want to get an audit

- A. Possible sale (or other exit strategy) of business
- B. Estate planning (audit enhances accuracy of business valuation, usually the center piece of any estate or succession planning, plus more accurate measurement of performance versus any plan)
- C. Control of cash/checks, other procedures to prevent fraud (audit does not look for fraud, but the management letter will outline any situations where lack of dual control or other security measures appear lax)

- VI. Understand the basis of presentation, especially the number of entities involved

- A. Single entity
- B. Multiple entities
 - 1. Consolidated with eliminating entries
 - 2. Combined with limited eliminating entries

- VII. Timing and receipt of financial statements

- A. Ideally within 60 days of business fiscal year-end (FYE), or if working from tax returns, within a few days of filing
- B. Getting on the correct "cycle" of the business, not your bank's tickler system

Sample Cover Letters

In October 2014, the American Institute of CPAs' (AICPA) Accounting and Review Services Committee released its new Statement on Standards for Accounting and Review Services No. 21 (SSARS 21). The new standards are considered by the profession to be the most substantial change to accounting standards since the 1970s. Plus, it introduced a financial reporting gift: a new level of service called *preparation of financial statements*.

Prepared statements, or engagements to prepare financial statements are the least informative of the externally prepared financial statements. The new level of service applies when a CPA is engaged to prepare financial statements, but not engaged to perform an audit, review, or compilation. Like the compilation, the preparation of financial statements is a non-assurance service, it requires an engagement letter, can omit notes, and can be used outside of management. Unlike the compilation, however, there is no disclosure requirement regarding the CPA's independence, and the financial statements do not have to be accompanied by a report.

In terms of disclosures, the preparation engagement only requires a legend on each page stating that no assurance is provided. The name of the CPA firm is not required. If the financial statements were prepared according to a special-purpose financial reporting framework (such as modified cash basis), a description of the framework should be added on the face of the financial statements or as a note. If the CPA is aware of a departure from GAAP or other chosen financial reporting framework, a disclosure should be added on the face of the financial statements or as a note. If the departure was intended to mislead users, the CPA should not prepare the financial statements.

Accountant's Cover Letter Excerpt – Prepared Financial Statements/Disclaimer

To Management of ABC Company:

The accompanying financial statements of ABC Company as of and for the year ended December 31, 20XX, were not subjected to an audit, review, or compilation engagement by us and we do not express an opinion, a conclusion, nor provide any assurance on them.

This level of service was not codified until SSARS 21 and helps to bring the standards more in line with the needs of users who do not require a report, particularly among privately held companies.

From a user perspective, when financial statements are to be distributed to third parties, the preparation engagement is expected to be more convenient and efficient than the predecessor compilation engagement. Clients that previously received management-use-only financial statements can now freely distribute those financial statements to third parties if or when necessary. In the past, the client would be prohibited from doing so unless the financial statements were upgraded to a compilation accompanied by a report.

From the CPA firm's perspective, the preparation engagement makes it easier to provide outsourced accounting/controller/CFO (often cloud-based) services in a way that is cost-effective relative to non-CPA firm competitors or internal staff. The provider no longer needs to choose between issuing a compilation report (at a greater cost to the client or to itself) or restricting the financial statements to management's use only. In addition, CPAs no longer have to be concerned about whether simply submitting the financial statements would be a trigger for determining if a compilation report is required or not, a decision process that had become increasingly ambiguous with today's cloud-based accounting systems. With AR-C Section 70, CPAs can more easily adapt their services to the realities of today's business environment.

Compiled statements are available to privately-owned entities only and provide no assurance of the quality or value of the statement data. One reason is that the numbers are simply restated or re-formatted from company records with little or no verification. Also, most compiled statements omit GAAP disclosures, including a statement of cash flows and footnotes. Persons preparing a compilation statement do not have to be independent of the customer's business, and this must be disclosed when applicable. While a compilation focuses on the format of the financial statements, an accountant is still required to document any communications to the appropriate level of management regarding fraud or illegal acts.

In late 2009 AICPA issued SSARS 19 that added materiality and evidence features to compilations and reviews, as well as requiring engagement letters. For compilations, an accountant was allowed to disclose the reason(s) for lack of independence, such as a member of the engagement team (1) having a direct financial interest in the business, (2) having an immediate family member employed by the business, or (3) serving along with the business owner or executive as an officer or major shareholder in another, separate business.

Compilation Qualifications

- possess general understanding of the customer's industry, business transactions and the form of accounting records
- be familiar with stated qualifications of the customer's accounting personnel to consider the need for adjustments to the account records
- read the financial statements and consider whether they are appropriate in form and content and free from obvious material errors

Most externally prepared financial statements provided by community bank customers are either *prepared* or *compiled*. Because of the limited process used by the accountant, the lender must thoroughly understand all the entries on the statement and the related accounting principles. Below is an excerpt from an accountant's cover letter for a compiled statement for ABC Company using the accrual basis of accounting. This example includes wording where the CPA has omitted a statement of cash flows and footnotes.

Accountant's Cover Letter Excerpt – Compiled Financial Statements – Accrual Basis

To Management of ABC Company:

Management is responsible for the accompanying financial statements of ABC Company (a corporation), which comprise the balance sheet of December 31, 20XX, and the related statements of income and retained earnings [and cash flows] for the year then ended [, and the related notes to the financial statements] in accordance with accounting principles generally accepted in the United States of America. We have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. We did not audit or review financial statements nor were we required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, we do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

A statement of cash flows for the year ended December 31, 20xx has not been presented. Accounting principles generally accepted in the United States of America require that such a statement be presented when financial statements purport to present financial position and results of operations.

Management has elected to omit substantially all the disclosures required by accounting principles generally accepted in the United States of America. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the Company's financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.

Compiled statements received by community bankers are sometimes prepared on the income tax basis of accounting. The underlying accounting method can be either cash or accrual, but then modified for tax rules. (Many community bank customers elect to use cash method accounting for tax returns.) Examples of adjustments for tax rules include certain types of income that are not taxable, while certain deductions or expenses are not allowed. Because tax rules allow depreciation on a basis usually more aggressive than "accelerated" methods used in most accounting systems, values for fixed assets, net of depreciation, will be different in an income tax basis balance sheet.

Reviewed Statements – Bankers generally consider reviewed statements to be an improvement over compiled statements, due to required inclusion of additional information, such as a statement of cash flows and footnotes explaining the statement. Reviewed statements are so named because an outside CPA reviews, but does not verify, the balance sheet and income statement. Similar to a compilation, this level of accounting engagement is available to privately owned entities only. Also similar to compilations, SSARS 19 added general procedures that CPAs must follow for reviews, including materiality and evidence concepts, plus an engagement letter requirement.

Review Qualifications

- know the accounting principles and practices of the customer's industry
- understand the customer's business, including its organization and operations
- inquire about accounting policies, record keeping procedures, and actions of owners and management that may affect financial statements and changes in business, activities or transactions
- identify and explain unusual items or trends in the financial statements
- determine that financial statements conform to GAAP
- be independent of the company

Nevertheless, a review remains significantly less comprehensive than an audit. The materiality and evidence concepts require the CPA to accumulate review evidence that will provide a reasonable basis for obtaining limited assurance that there are no material modifications that should be made to the financial statements. Overall, this process prevents CPAs from using a canned list of analytical and inquiry provisions. Rather, a tailored approach is needed, based on areas where the CPA believes increased risk for misstatements exist.

Accountant's Cover Letter Excerpt – Reviewed Financial Statements

To Management of ABC Company:

We have reviewed the accompanying financial statements of ABC Company (a corporation), which comprise the balance sheet as of December 31, 20XX, and the related statements of income and retained earnings, and cash flows for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement whether due to fraud or error.

Accountant's Responsibility

Our responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require us to perform procedures to obtain limited assurance as a basis for reporting whether we are of any material modifications that should be made to the financial statement for them to be in accordance with accounting principles generally accepted in the United States of America. We believe that the results of our procedures provide a reasonable basis for our conclusion.

Accountant's Conclusion

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

Audited statements are more thorough and expensive than compilations or reviews, and therefore are least often available to the community bankers. Most small, privately held companies cannot justify the cost and time involved, relative to the size of the business. Audits are required for public companies, which are usually very large businesses.

In an audit, the accountant performs a comprehensive evaluation of the borrower's accounting systems to determine the accuracy of the financial information and to verify that the statements conform to GAAP. Depending on the CPA's findings, several types of opinions can be rendered: unqualified, qualified, adverse and disclaimer.

- An unqualified audit opinion is often called a "clean" opinion, where the CPA feels that management has accurately reported its financial position, along with any changes and the operating results for the reported periods.

The term "clean" can be misleading and is not equivalent to "clean bill of health." An audit does not provide assurance about any positive or satisfactory rating of financial condition. In fact, the financial condition may be weak. The audit simply certifies the relative accuracy of the data reported. It is up to the user to determine the "health" of the underlying business.

Accountant's Cover Letter Excerpt – Audited Financial Statement – Unqualified Opinion

To Management of ABC Company:

We have audited the accompanying financial statements ABC Company (a corporation), which comprise the balance sheet as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20XX, 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.

- A qualified opinion occurs when the CPA has encountered one of two types of situations that do not comply with GAAP. Despite these departures, the rest of the financial statements are fairly presented. This type of opinion is very similar to an unqualified or "clean" opinion, but the report states that the financial statements are fairly presented with a certain exception which is otherwise misstated. Lenders need to fully understand the exception that was noted, but can otherwise treat the financial statements similar to an unqualified audit.

The two types of situations that can cause a CPA to issue a qualified opinion are:

1. *Single deviation from GAAP* when one or more areas of the financial statements do not conform with GAAP, or misstate an item, but do not affect the rest of the financial statements from being fairly presented when taken as a whole. Examples include a company that did not correctly calculate the depreciation expense of its building. Even if this expense

is considered material, since the rest of the financial statements do conform with GAAP, then the auditor qualifies the opinion by describing the depreciation misstatement in the report and continues to issue an unqualified opinion on the rest of the financial statements.

2. *Limitation of scope* occurs when the auditor could not audit one or more areas of the financial statements, and although they could not be verified, the rest of the financial statements were audited and they conform with GAAP. Examples of this include an auditor not being able to observe and test a company's inventory in a prior period. This can happen if the business has changed accounting firms, or the current CPA may not have access to the older inventory records, which can happen after a natural disaster. If the CPA audited the rest of the financial statements and is reasonably sure that they conform with GAAP, then the auditor simply states that the financial statements are fairly presented, with the exception of the inventory which could not be audited.

The wording of the qualified opinion is very similar to the unqualified opinion, but with an *explanatory paragraph* is added. The scope and the opinion paragraphs receive a slight modification in line with the qualification in the explanatory paragraph. The key phrasing to look for is "*Except as discussed in the following paragraph, we conducted our audit . . .*" Some bankers refer to a qualified audit as a "except for" opinion. Some opinions include the wording "subject to."

Below is a qualified opinion for ABC Company. In this example the company has not capitalized or has excluded from reported liabilities some of its lease obligations, which violates GAAP in certain situations.

Accountant's Cover Letter Excerpt – Audited Financial Statement – Qualified Opinion

To Management of ABC Company:

We have audited the accompanying financial statements ABC Company (a corporation), which comprise the balance sheet as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of

accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

The Company has excluded from property and debt in the accompanying balance sheets certain lease obligations that, in our opinion, should be capitalized in order to conform to accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by \$X thousand, long-term debt would be increased by \$X thousand, the current portion of long-term debt would be increased by \$X thousand, and retained earnings would increase by \$X thousand as of December 31, 20XX. Additionally, net income would be increased by \$X thousand and earnings per share would be increased by \$X.XX, for the year ended December 31, 20XX.

Opinion

In our opinion, except for the effects of not capitalizing certain lease obligations as disclosed in the above paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20XX, 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.

- An adverse opinion occurs when the CPA determines that the financial statements are materially misstated and, when considered as a whole, do not conform with GAAP. It is considered the opposite of an unqualified opinion, essentially saying that the information contained is materially incorrect, unreliable, and inaccurate in order to assess financial position and results of operations of the business. Most investors and bankers very rarely accept an audit with an adverse opinion, and usually request the business to correct the financial statements and obtain another audit report.

Generally, an adverse opinion is given only if the financial statements pervasively differ from GAAP. An example of such a situation would be failure of a company to consolidate a material subsidiary. Further, the wording of the adverse report is similar to a qualified report. The scope paragraph is modified accordingly and an explanatory paragraph is added to cover the reason for the adverse opinion. However, the most significant change in the adverse report from the qualified report is in the opinion paragraph, where the auditor clearly states that the financial statements are not in accordance with GAAP, which means that they, as a whole, are unreliable, inaccurate, and do not present a fair view of the company's position and operations. Look for wording similar to "In our opinion, *because of the situations mentioned above* (in the explanatory paragraph), the financial statements referred to in the first paragraph *do not* present fairly, in all material respects, the financial position of . . ."

Below is an adverse opinion for ABC Company. In this example the company has been valuing fixed assets at appraised values, compared to GAAP's cost basis, with subsequent effects on depreciation expense, deferred taxes, cost of goods sold and other accounts.

Accountant's Cover Letter Excerpt – Audited Financial Statement – Adverse Opinion

To Management of ABC Company:

We have audited the accompanying financial statements ABC Company (a corporation), which comprise the balance sheet as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

As discussed in Note X to the financial statements, the Company carries its property, plant, and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not recognize deferred income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Accounting principles generally accepted in the United States of America require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be recognized.

Because of the departures from accounting principles generally accepted in the United States of America and discussed in the preceding paragraph, as of December 31, 20XX, inventories have been increased by \$X thousand by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is carried at \$X thousand in excess of an amount based on the cost to the company; and deferred income taxes of \$X thousand have not been recognized, resulting in an increase of \$X thousand in retained earnings and in appraisal surplus of \$X thousand, respectively. For the year ended December 31, 20XX cost of goods sold has been increased \$X thousand, because of the effects of the depreciation accounting referred to above, and deferred income taxes of \$X thousand have not been recognized, resulting in an increase in net income of \$X thousand.

Opinion

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in all material respects, the financial position of ABC Company as of December 31, 20XX, 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.

- A going concern disclosure opinion is perhaps the only accountant report where an indication of the “health” of the underlying business is made. *Going concern* means that the business will continue to operate in the near future, or generally more than next 12 months, so long as it generates or obtains enough resources to operate. If the business is **not** a going concern, it means that it is either dissolved, bankrupt or closed. If the CPA considers that the business is not a going concern, or will not be a going concern in the near future, then the audit cover letter includes a paragraph explaining the situation, which is called the going concern disclosure.

For obvious reasons, a disclosure for a lack of going concern is viewed negatively by investors and bankers, and therefore reduces the chance that the business may obtain the capital or borrowing it needs to survive once the disclosure is made.

Below is the going concern disclosure for ABC Company. In this example the company has generated net losses over several years and has a negative net worth. The cover letter will have the same text, in its entirety, as the unqualified opinion cover letter example shown earlier. However, it will add the following paragraph at the end of the unqualified opinion text.

Accountant’s Cover Letter Excerpt – Audited Financial Statement – Going Concern Disclosure

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses and has a net capital deficiency. These conditions raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments relating to the recoverability and classification of asset carrying amounts or the amount and classification of liabilities that might result should the Company be unable to continue as a going concern.

- A disclaimer of opinion is not really an opinion at all. This type of report is issued when the CPA tried to audit an entity but could not complete the work due to various reasons and does not issue an opinion. Statements on Auditing Standards (SAS) provide certain situations where a disclaimer of opinion may be appropriate:
 - A lack of independence or material conflict(s) of interest exist between the CPA and the business
 - There are significant scope limitations, whether intentional or not, which hinder the CPA’s work in obtaining evidence and performing procedures
 - There is a substantial doubt about the company’s ability to continue as a going concern
 - There are significant uncertainties within the business

Although this type of opinion is rarely used, a common example includes an audit where the company willfully hides or refuses to provide evidence and information in significant areas of the financial statements, where the company is facing significant legal and litigation issues in which the outcome is uncertain (usually government investigations), and where going concern issues exist. Investors and bankers typically reject such financial statements and will request the company to correct the situations the auditor mentioned and obtain another report.

A disclaimer of opinion differs substantially from the rest of the auditor’s reports because it provides very little information regarding the audit itself, although it includes an explanatory paragraph stating the reasons for the disclaimer. Almost every paragraph is modified

extensively, and the scope paragraph is entirely omitted since the auditor is basically stating that an audit opinion could not be formed. Other changes include

- In the introductory paragraph, the first phrase changes from “We have audited” to “We were engaged to audit” and does not mention that the auditor necessarily completed the audit.
- The auditor refuses to accept any responsibility by omitting the last sentence of the first paragraph.
- The opinion paragraph changes completely, stating that an opinion could not be formed and is not expressed because of the situations mentioned in the previous paragraphs.

Below is a disclaimer of opinion report for ABC Company, which (in this example) did not count its inventory or provide documents to support the cost of property and equipment. GAAP requires inventory to be counted at least annually. Furthermore, GAAP requires companies to retain records to support the cost of fixed assets.

Accountant’s Cover Letter Excerpt – Audited Financial Statement – Disclaimer of Opinion

To Management of ABC Company:

We have audited the accompanying financial statements ABC Company (a corporation), which comprise the balance sheet as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, and the related notes to the financial statements.

Management’s Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

The company did not make a count of its physical inventory in 20XX, stated in the accompanying financial statements at \$X thousand as of December 31, 20XX as of December 31, 20XX. Furthermore, evidence supporting the cost of property and equipment acquired prior to December 31, 20XX is no longer available. The company’s records do not permit the application of other auditing procedures to inventories or property and equipment.

Opinion

Because the company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

To summarize the types of audit cover letters and opinions: a qualified opinion is generally comparable to an unqualified opinion and, depending on the reason for the qualification, is usually suitable. A financial statement with the disclaimer opinion would be considered unaudited, but could be prepared in accordance with GAAP. The adverse opinion is of questionable value in a financial analysis, as is a going concern disclosure.

Management Letter – A CPA usually issues a management letter along with audited financial statements. This letter, sent to the board of directors or management of the company, expresses concerns or deficiencies not referred to in the audit. The auditing CPA includes information describing the reportable conditions as well as information about any material weaknesses that do not reduce risk of error or irregularities. Reportable conditions include accuracy of computer-generated information due to obsolete software or lack of dual control over certain procedures. Material weaknesses include inventory not properly monitored or employee theft.