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Auditing health care third-party revenues and related receivables; Statement of position 00-1;

American Institute of Certified Public Accountants. Health Care Third-Party Revenue Recognition Task Force

STATEMENT OF POSITION 00-1

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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Auditing Health Care Third-Party Revenues and Related Receivables

Issued Under the Authority of the Auditing Standards Board

NOTE

This Statement of Position presents the recommendations of the AICPA Health Care Third-Party Revenue Recognition Task Force with regard to auditing financial statement assertions about third-party revenues and related receivables of health care entities. The Auditing Standards Board has found the recommendations in this Statement of Position to be consistent with existing standards covered by rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

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SUMMARY

This Statement of Position provides guidance to auditors regarding uncertainties inherent in health care third-party revenue recognition. It discusses auditing matters to consider in testing third-party revenues and related receivables, and provides guidance regarding the sufficiency of evidential matter and reporting on financial statements of health care entities exposed to material uncertainties.

Auditing Health Care Third-Party Revenues and Related Receivables

Introduction and Background

1. Most health care providers participate in payment programs that pay less than full charges for services rendered. For example, some cost-based programs retrospectively determine the final amounts reimbursable for services rendered to their beneficiaries based on allowable costs. With increasing frequency, even non-cost-based programs (such as the Medicare Prospective Payment System) have become subject to retrospective adjustments (for example, billing denials and coding changes). Often, such adjustments are not known for a considerable period of time after the related services were rendered.

2. The lengthy period of time between rendering services and reaching final settlement, compounded further by the complexities and ambiguities of reimbursement regulations, makes it difficult to estimate the net patient service revenue associated with these programs. This situation has been compounded due to the frequency of changes in federal program guidelines.

3. The AICPA Audit and Accounting Guide *Health Care Organizations* (the Guide) requires that patient revenues be reported net of provisions for contractual and other adjustments (paragraph 10.20). As a result, patient receivables, including amounts due from third-party payors, are also reported net of expected contractual and other adjustments. However, amounts ultimately realizable will not be known until some future date, which may be several years after the period in which the services were rendered.

4. This Statement of Position (SOP) provides guidance to auditors regarding uncertainties inherent in health care third-party revenue recognition. It discusses auditing matters to consider in testing third-party revenue and related receiv-

ables, including the effects of settlements (both cost-based and non-cost-based third-party payment programs), and provides guidance regarding the sufficiency of evidential matter and reporting on financial statements of health care entities exposed to material uncertainties.

Scope and Applicability

5. This SOP applies to audits of health care organizations falling within the scope of the Guide. Its provisions are effective for audits of periods ending on or after June 30, 2000. Early application of the provisions of this SOP is permitted.

Third-Party Revenues and Related Receivables—Inherent Uncertainties

6. Health care entities need to estimate amounts that ultimately will be realizable in order for revenues to be fairly stated in accordance with generally accepted accounting principles (GAAP). The basis for such estimates may range from relatively straightforward calculations using information that is readily available to highly complex judgments based on assumptions about future decisions.

7. Entities doing business with governmental payors (for example, Medicare and Medicaid) are subject to risks unique to the government-contracting environment that are hard to anticipate and quantify and that may vary from entity to entity. For example—

    - A health care entity's revenues may be subject to adjustment as a result of examination by government agencies or contractors. The audit process and the resolution of significant related matters (including disputes based on differing interpretations of the regulations) often are not finalized until several years after the services were rendered.
    - Different fiscal intermediaries (entities that contract with the federal government to assist in the administration of the Medicare program) may interpret governmental regulations differently.

- Differing opinions on a patient's principal medical diagnosis, including the appropriate sequencing of codes used to submit claims for payment, can have a significant effect on the payment amount.[1]
- Otherwise valid claims may be determined to be nonallowable after the fact due to differing opinions on medical necessity.
- Claims for services rendered may be nonallowable if they are later determined to have been based on inappropriate referrals.[2]
- Governmental agencies may make changes in program interpretations, requirements, or "conditions of participation," some of which may have implications for amounts previously estimated.

8. Such factors often result in retrospective adjustments to interim payments. Reasonable estimates of such adjustments are central to the third-party revenue recognition process in health care, in order to avoid recognizing revenue that the provider will not ultimately realize. The delay between rendering services and reaching final settlement, as well as the complexities and ambiguities of billing and reimbursement regulations, makes it difficult to estimate net realizable third-party revenues.

Management's Responsibilities

9. Management is responsible for the fair presentation of its financial statements in conformity with GAAP. Management also is responsible for adopting sound accounting policies

1. Historically, the Health Care Financing Administration (HCFA) contracted with Peer Review Organizations (PROs) to validate the appropriateness of admissions and the clinical coding from which reimbursement was determined. Such reviews were typically performed within ninety days of the claim submission date. However, the government has modified its policies with respect to such reviews and now analyzes coding errors through other means, including in conjunction with investigations conducted by the Office of the Inspector General (OIG) of the U. S. Department of Health and Human Services.
2. Effective January 1, 1995, the Limitation on Certain Physician Referrals law prohibited physicians from referring Medicare and Medicaid patients to health care organizations with which they had a financial relationship for the furnishing of designated health services. Implementing regulations have not yet been adopted as of the date of this publication.

and for establishing and maintaining internal control that will, among other things, record, process, summarize, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements. Despite the inherent uncertainties, management is responsible for estimating the amounts recorded in the financial statements and making the required disclosures in accordance with GAAP, based on management's analysis of existing conditions.

10. Management's assertions regarding proper valuation of its revenues and receivables are embodied in the financial statements. Management is responsible for assuring that revenues are not recognized until their realization is reasonably assured. As a result, management makes a reasonable estimate of amounts that ultimately will be realized, considering—among other things—adjustments associated with regulatory reviews, audits, billing reviews, investigations, or other proceedings. Estimates that are significant to management's assertions about revenue include the provision for third-party payor contractual adjustments and allowances.

11. Management also is responsible for preparing and certifying cost reports submitted to federal and state government agencies in support of claims for payment for services rendered to government program beneficiaries.

The Auditor's Responsibilities

12. The auditor's responsibility is to express an opinion on the financial statements taken as a whole. In reaching this opinion, the auditor considers the evidence in support of recorded amounts. If amounts are not known with certainty, the auditor considers the reasonableness of management's estimates in the present circumstances. The auditor also considers the fairness of the presentation and adequacy of the disclosures made by management.

13. In planning the audit, the auditor considers current industry conditions, as well as specific matters affecting the entity.[3]

3. Risk factors, including ones related to legislative and regulatory matters, are discussed annually in the AICPA Audit Risk Alert *Health Care Industry Developments*.

Among a number of things, the auditor's procedures typically include an analysis of historical results (for example, prior fiscal intermediary audit adjustments and comparisons with industry benchmarks and norms) that enable the auditor to better assess the risk of material misstatements in the current period. When there are heightened risks, the auditor performs more extensive tests covering the current period. Exhibit 5.1 of the Guide includes a number of examples of procedures that auditors may consider.

14. With respect to auditing third-party revenues, in addition to the usual revenue recognition considerations, the auditor considers whether amounts ultimately realizable are or should be presently known or are uncertain because they are dependent on some other future, prospective actions or confirming events. For example, under a typical fee-for-service contract with a commercial payor, if the provider has performed a service for a covered individual, the revenue to which the provider is entitled should be determinable at the time the service is rendered. On the other hand, if the service was provided under a cost-based government contract, the revenue ultimately collectible may not be known until certain future events occur (for example, a cost report has been submitted and finalized after desk review or audit). In this case, management estimates the effect of such potential future adjustments.

15. As stated previously, management is responsible for preparing the estimates contained in the financial statements. The auditor evaluates the adequacy of the evidence supporting those estimates, reviews the facts supporting management's judgments, and evaluates the judgments made based on conditions existing at the time of the audit. The fact that net revenues recorded at the time services are rendered differ materially from amounts that ultimately are realized does not necessarily mean the audit was not properly planned or carried out. Similarly, the fact that future events may differ materially from management's assumptions or estimates does not necessarily mean that management's estimates were not valid or the auditor did not follow generally accepted auditing standards (GAAS) as described in this SOP with respect to auditing estimates.

Evidential Matter

16. The measurement of estimates is inherently uncertain and depends on the outcome of future events. Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), and SAS No. 79, *Amendment to SAS No. 58*, Reports on Audited Financial Statements (AICPA, *Professional Standards*, vol. 1, AU sec. 508) provide guidance to the auditor when the valuation of revenues is uncertain, pending the outcome of future events. In the current health care environment, conclusive evidence concerning amounts ultimately realizable cannot be expected to exist at the time of the financial statement audit because the uncertainty associated with future program audits, administrative reviews, billing reviews, regulatory investigations, or other actions will not be resolved until sometime in the future.

17. The fact that information related to the effects of future program audits, administrative reviews, regulatory investigations, or other actions does not exist does not lead to a conclusion that the evidential matter supporting management's assertions is not sufficient to support management's estimates. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is available or can reasonably be expected to be available in the circumstances. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertions about the valuation of revenues and receivables, and their presentation and disclosure in the financial statements, an unqualified opinion ordinarily is appropriate.

18. If relevant evidential matter exists that the auditor needs and is unable to obtain, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. For example, if an entity has conducted an internal evaluation (for example, of coding or other billing matters) under attorney–client privilege and management and its legal counsel refuse to respond to the auditor's inquiries and the auditor determines the infor-

mation is necessary, ordinarily the auditor qualifies his or her opinion for a scope limitation.

19. The auditor considers the reasonableness of management's assumptions in light of the entity's historical experience and the auditor's knowledge of general industry conditions, because the accuracy of management's assumptions will not be known until future events occur. For certain matters, the best evidential matter available to the auditor (particularly as it relates to clinical and legal interpretations) may be the representations of management and its legal counsel, as well as information obtained through reviewing correspondence from regulatory agencies.

20. Pursuant to SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), the auditor should obtain written representations from management concerning the absence of violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency. Examples of specific representations include the following:

- Receivables
  - Adequate consideration has been given to, and appropriate provision made for, estimated adjustments to revenue, such as for denied claims and changes to diagnosis-related group (DRG) assignments.
  - Recorded valuation allowances are necessary, appropriate, and properly supported.
  - All peer review organizations, fiscal intermediary, and third-party payor reports and information have been made available.
- Cost reports filed with third parties
  - All required Medicare, Medicaid, and similar reports have been properly filed.
  - Management is responsible for the accuracy and propriety of all cost reports filed.
  - All costs reflected on such reports are appropriate and allowable under applicable reimbursement

rules and regulations and are patient-related and properly allocated to applicable payors.

- The reimbursement methodologies and principles employed are in accordance with applicable rules and regulations.
- Adequate consideration has been given to, and appropriate provision made for, audit adjustments by intermediaries, third-party payors, or other regulatory agencies.
- All items required to be disclosed, including disputed costs that are being claimed to establish a basis for a subsequent appeal, have been fully disclosed in the cost report.
- Recorded third-party settlements include differences between filed (and to be filed) cost reports and calculated settlements, which are necessary based on historical experience or new or ambiguous regulations that may be subject to differing interpretations. While management believes the entity is entitled to all amounts claimed on the cost reports, management also believes the amounts of these differences are appropriate.

- Contingencies
  - There are no violations or possible violations of laws or regulations, such as those related to the Medicare and Medicaid antifraud and abuse statutes, including but not limited to the Medicare and Medicaid Anti-Kickback Statute, Limitations on Certain Physician Referrals (the Stark law), and the False Claims Act, in any jurisdiction, whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency other than those disclosed or accrued in the financial statements.
  - Billings to third-party payors comply in all material respects with applicable coding guidelines (for example, ICD-9-CM and CPT-4) and laws and regulations (including those dealing with Medicare and Medicaid antifraud and abuse), and billings reflect

only charges for goods and services that were medically necessary; properly approved by regulatory bodies (for example, the Food and Drug Administration), if required; and properly rendered.

- There have been no communications (oral or written) from regulatory agencies, governmental representatives, employees, or others concerning investigations or allegations of noncompliance with laws and regulations in any jurisdiction (including those related to the Medicare and Medicaid antifraud and abuse statutes), deficiencies in financial reporting practices, or other matters that could have a material adverse effect on the financial statements.

21. Management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause an auditor to disclaim an opinion or withdraw from the engagement. However, based on the nature of the representations not obtained or the circumstances of the refusal, the auditor may conclude that a qualified opinion is appropriate.

Potential Departures From GAAP Related to Estimates and Uncertainties

22. In addition to examining the evidence in support of management's estimates, the auditor determines that there has not been a departure from GAAP with respect to the reporting of those estimates in the financial statements. Such departures generally fall into one of the following categories:

    - Unreasonable accounting estimates
    - Inappropriate accounting principles
    - Inadequate disclosure

    Therefore, in order to render an opinion, the auditor's responsibility is to evaluate the reasonableness of management's estimates based on present circumstances and to determine that estimates are reported in accordance with GAAP and adequately disclosed.

23. As discussed in SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), the auditor's objective is to obtain sufficient competent evidential matter to provide him or her with a reasonable basis for forming an opinion. As discussed previously, exhibit 5.1 of the Guide provides a number of sample procedures that the auditor might consider in auditing an entity's patient revenues and accounts receivable, including those derived from third-party payors. For example, the Guide notes that the auditor might "test the reasonableness of settlement amounts, including specific and unallocated reserves, in light of the payors involved, the nature of the payment mechanism, the risks associated with future audits, and other relevant factors."[4]

Unreasonable Accounting Estimates

24. In evaluating the reasonableness of management's estimates, the auditor considers the basis for management's assumptions regarding the nature of future adjustments and management's calculations as to the effects of such adjustments.[5] The auditor cannot determine with certainty whether such estimates are right or wrong, because the accuracy of management's assumptions cannot be confirmed until future events occur.

25. Though difficult to predict, it is reasonable for the auditor to expect that management has made certain assumptions (either in detail or in the aggregate) in developing its estimates regarding conditions likely to result in adjustments. The auditor gathers evidence regarding the reasonableness of the estimates (for example, consistency with historical experience and basis of management's underlying assumptions). In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches:

4. See paragraphs 25–28.

5. The lack of such analyses may call into question the reasonableness of recorded amounts.

a. Review and test the process used by management to develop the estimate.

b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimates.

c. Review subsequent events or transactions occurring prior to completion of fieldwork (AU sec. 342.10).

26. Since no one accounting estimate can be considered accurate with certainty, the auditor recognizes that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely misstatement. However, if the auditor believes the estimated amount included in the financial statements is unreasonable, he or she should treat the difference between that estimate and the closest reasonable estimate in the range as a likely misstatement and aggregate it with other likely misstatements. The auditor also should consider whether the difference between estimates best supported by the audit evidence and the estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the entity's management. For example, if each accounting estimate included in the financial statements was individually reasonable, but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase income, the auditor should reconsider the reasonableness of the estimates taken as a whole (SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* [AICPA, *Professional Standards*, vol. 1, AU sec. 312.36]).

27. The auditor recognizes that approaches and estimates will vary from entity to entity. Some entities with significant prior experience may attempt to quantify the effects of individual potential intermediary or other governmental (for example, the Office of Inspector General and the Department of Justice) or private payor adjustments, basing their estimates on very detailed calculations and assumptions

regarding potential future adjustments. Some may prepare cost report[6] analyses to estimate the effect of potential adjustments. Others may base their estimates on an analysis of potential adjustments in the aggregate, in light of the payors involved; the nature of the payment mechanism; the risks associated with future audits; and other relevant factors.

28. Normally, the auditor considers the historical experience of the entity (for example, the aggregate amount of prior cost-report adjustments and previous regulatory settlements) as well as the risk of potential future adjustments. The fact that an entity currently is not subject to a governmental investigation does not mean that a recorded valuation allowance for potential billing adjustments is not warranted. Nor do these emerging industry trends necessarily indicate that an accrual for a specific entity is warranted.

29. In evaluating valuation allowances, the auditor may consider the entity's historical experience and potential future adjustments in the aggregate. For example, assume that over the past few years after final cost report audits were completed, a hospital's adjustments averaged 3 percent to 5 percent of total filed reimbursable costs. Additionally, the hospital is subject to potential billing adjustments, including errors (for example, violations of the three-day window, discharge and transfer issues, and coding errors). Even though specific incidents are not known, it may be reasonable for the hospital to estimate and accrue a valuation allowance for such potential future retrospective adjustments, both cost-based and non-cost-based. Based on this and other information obtained, the auditor may conclude that a valuation allowance for the year under audit of 3 percent to 5 per-

6. Medicare cost reimbursement is based on the application of highly complex technical rules, some of which are ambiguous and subject to different interpretations even among Medicare's fiscal intermediaries. It is not uncommon for fiscal intermediaries to reduce claims for reimbursement that were based on management's good faith interpretations of pertinent laws and regulations. Additionally, the Provider Reimbursement Review Board (PRRB) or the courts may be required to resolve controversies regarding the application of certain rules. To avoid recognizing revenues before their realization is reasonably assured, providers estimate the effects of such potential adjustments. This is occasionally done by preparing a cost report based on alternative assumptions to help estimate contractual allowances required by generally accepted accounting principles. The existence of reserves or a reserve cost report does not by itself mean that a cost report was incorrectly or fraudulently filed.

cent of reimbursable costs plus additional amounts for potential non-cost-based program billing errors is reasonable.

30. Amounts that ultimately will be realized by an entity are dependent on a number of factors, many of which may be unknown at the time the estimate is first made. Further, even if two entities had exactly the same clinical and coding experience, amounts that each might realize could vary materially due to factors outside of their control (for example, differing application of payment rules by fiscal intermediaries, legal interpretations of courts, local enforcement initiatives, timeliness of reviews, and quality of documentation). As a result, because estimates are a matter of judgment and their ultimate accuracy depends on the outcome of future events, different entities in seemingly similar circumstances may develop materially different estimates. The auditor may conclude that both estimates are reasonable in light of the differing assumptions.

Inappropriate Accounting Principles

31. The auditor also determines that estimates are presented in the financial statements in accordance with GAAP. If the auditor believes that the accounting principles have not been applied correctly, causing the financial statements to be materially misstated, the auditor expresses a qualified or adverse opinion.

32. Valuation allowances are recorded so that revenues are not recognized until the revenues are realizable. Valuation allowances are not established based on the provisions of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*.

33. The auditor should be alert for valuation allowances not associated with any particular program, issue, or time period (for example, cost-report year or year the service was rendered). Such a reserve may indicate measurement bias. The auditor also considers the possibility of bias resulting in distorted earnings trends over time (for example, building up specific or unallocated valuation allowances in profitable years and drawing them down in unprofitable years).

Inadequate Disclosure

34. If the auditor concludes that a matter involving a risk or an uncertainty is not adequately disclosed in the financial statements in conformity with GAAP, the auditor should express a qualified or adverse opinion. SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, provides guidance on the information that reporting entities should disclose regarding risks and uncertainties existing as of the date of the financial statements.

35. In the health care environment, it is almost always at least reasonably possible that estimates regarding third-party payments could change in the near term as a result of one or more future confirming events (for example, regulatory actions reflecting local or national audit or enforcement initiatives). For most entities with significant third-party revenues, the effect of the change could be material to the financial statements. Where material exposure exists, the uncertainty regarding revenue realization is disclosed in the notes to the financial statements. Because representations from legal counsel are often key audit evidence in evaluating the reasonableness of management's estimates of potential future adjustments, the inability of an attorney to form an opinion on matters about which he or she has been consulted may be indicative of an uncertainty that should be specifically disclosed in the financial statements.

36. Differences between original estimates and subsequent revisions might arise due to final settlements, ongoing audits and investigations, or passage of time in relation to the statute of limitations. The Guide (paragraph 5.07) requires that these differences be included in the statement of operations in the period in which the revisions are made and disclosed, if material. Such differences are not treated as prior period adjustments unless they meet the criteria for prior period adjustments as set forth in FASB Statement No. 16, *Prior Period Adjustments*.

37. Disclosures such as the following may be appropriate:

> General Hospital (the Hospital) is a (not-for-profit, for-profit, or governmental hospital or health care system)

located in (City, State). The Hospital provides health care services primarily to residents of the region.

Net patient service revenue is reported at estimated net realizable amounts from patients, third-party payors, and others for services rendered and includes estimated retroactive revenue adjustments due to future audits, reviews, and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews, and investigations.

Revenue from the Medicare and Medicaid programs accounted for approximately 40 percent and 10 percent, respectively, of the Hospital's net patient revenue for the year ended 1999. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. The 1999 net patient service revenue increased approximately $10,000,000 due to removal of allowances previously estimated that are no longer necessary as a result of final settlements and years that are no longer subject to audits, reviews, and investigations. The 1998 net patient service revenue decreased approximately $8,000,000 due to prior-year retroactive adjustments in excess of amounts previously estimated.

APPENDIX

Other Considerations Related to Government Investigations

In recent years, the federal government and many states have aggressively increased enforcement efforts under Medicare and Medicaid anti-fraud and abuse legislation. Broadening regulatory and legal interpretations have significantly increased the risk of penalties for providers; for example, broad interpretations of "false claims" laws are exposing ordinary billing mistakes to scrutiny and penalty consideration. In such circumstances, evaluating the adequacy of accruals for or disclosure of the potential effects of illegal acts in the financial statements of health care organizations is a matter that is likely to require a high level of professional judgment.

As previously discussed in this Statement of Position (SOP), the far-reaching nature of alleged fraud and abuse violations creates an uncertainty with respect to the valuation of revenues, because future allegations of illegal acts could, if proven, result in a subsequent reduction of revenues. In addition, management makes provisions in the financial statements and disclosures for any contingent liabilities associated with fines and penalties due to violations of such laws. Financial Accounting Standards Board Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, provides guidance in evaluating contingent liabilities, such as fines and penalties under applicable laws and regulations. Estimates of potential fines and penalties are not accrued unless their payment is probable and reasonably estimable.

The auditor's expertise is in accounting and auditing matters rather than operational, clinical, or legal matters. Accordingly, the auditor's procedures focus on areas that normally are subject to internal controls relevant to finan-

cial reporting. However, the further that potential illegal acts are removed from the events and transactions ordinarily reflected in the financial statements, the less likely the auditor is to become aware of the act, to recognize its possible illegality, and to evaluate the effect on the financial statements. For example, determining whether a service was medically necessary, obtained through a legally appropriate referral, properly performed (including using only approved devices, rendered in a quality manner), adequately supervised, accurately documented and classified, or rendered and billed by nonsanctioned individuals typically is not within the auditor's professional expertise. As a result, an audit in accordance with generally accepted auditing standards (GAAS) is not designed to detect such matters.

Further, an audit conducted in accordance with GAAS does not include rendering an opinion or any form of assurance on an entity's compliance with laws and regulations.[1] Nor does an audit under GAAS include providing any assurance on an entity's billings or cost report. In fact, cost reports typically are not prepared and submitted until after the financial statement audit has been completed.

Certain audit procedures, although not specifically designed to detect illegal acts, may bring possible illegal acts to an auditor's attention. When a potentially illegal act is detected, the auditor's responsibilities are addressed in Statement on Auditing Standards No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). Disclosure of an illegal act to parties other than the client's senior management and its audit committee or board of directors is not ordinarily part of the auditor's responsibility, and such disclosure would be precluded by the auditor's ethical or legal obligation of confidentiality, unless the matter affects the auditor's opinion on the financial statements.[2]

1. Even when auditors undertake a special engagement designed to attest to compliance with certain provisions of laws, regulations, contracts, and grants (for example, an audit in accordance with OMB Circular A-133), the auditor's procedures do not extend to testing compliance with laws and regulations related to Medicare and Medicaid fraud and abuse.

2. Statement on Auditing Standards No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU 317.23) discusses circumstances in which a duty to notify parties outside the client of detected illegal acts may exist.

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