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Attestation Standards

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AT

STATEMENTS ON STANDARDS FOR ATTESTATION ENGAGEMENTS

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ATTESTATION STANDARDS

Introduction

The accompanying "attestation standards" provide guidance and establish a broad framework for a variety of attest services increasingly demanded of the accounting profession. The standards and related interpretive commentary are designed to provide professional guidelines that will enhance both consistency and quality in the performance of such services.

For years, attest services generally were limited to expressing a positive opinion on historical financial statements on the basis of an audit in accordance with generally accepted auditing standards (GAAS). However, certified public accountants increasingly have been requested to provide, and have been providing, assurance on representations other than historical financial statements and in forms other than the positive opinion. In responding to these needs, certified public accountants have been able to generally apply the basic concepts underlying GAAS to these attest services. As the range of attest services has grown, however, it has become increasingly difficult to do so.

Consequently, the main objective of adopting these attestation standards and the related interpretive commentary is to provide a general framework for and set reasonable boundaries around the attest function. As such, the standards and commentary (a) provide useful and necessary guidance to certified public accountants engaged to perform new and evolving attest services and (b) guide AICPA standard-setting bodies in establishing, if deemed necessary, interpretive standards for such services.

The attestation standards are a natural extension of the ten generally accepted auditing standards. Like the auditing standards, the attestation standards deal with the need for technical competence, independence in mental attitude, due professional care, adequate planning and supervision, sufficient evidence, and appropriate reporting; however, they are much broader in scope. (The eleven attestation standards are listed below.) Such standards apply to a growing array of attest services. These services include, for example, reports on descriptions of systems of internal accounting control; on descriptions of computer software; on compliance with statutory, regulatory, and contractual requirements; on investment performance statistics; and on information supplementary to financial statements. Thus, the standards have been developed to be responsive to a changing environment and the demands of society.

These attestation standards apply only to attest services rendered by a certified public accountant in the practice of public accounting—that is, a practitioner as defined in footnote 1 of paragraph .01.

The attestation standards do not supersede any of the existing standards in Statements on Auditing Standards (SASs), Statements on Standards for Accounting and Review Services (SSARSs), and Statement on Standards for Accountants' Services on Prospective Financial Information. Therefore, the practitioner who is engaged to perform an engagement subject to these existing standards should follow such standards.

Attestation Standards

General Standards

1. The engagement shall be performed by a practitioner or practitioners having adequate technical training and proficiency in the attest function.
2. The engagement shall be performed by a practitioner or practitioners having adequate knowledge in the subject matter of the assertion.
3. The practitioner shall perform an engagement only if he or she has reason to believe that the following two conditions exist:
   - The assertion is capable of evaluation against reasonable criteria that either have been established by a recognized body or are stated in the presentation of the assertion in a sufficiently clear and comprehensive manner for a knowledgeable reader to be able to understand them.
   - The assertion is capable of reasonably consistent estimation or measurement using such criteria.
4. In all matters relating to the engagement, an independence in mental attitude shall be maintained by the practitioner or practitioners.
5. Due professional care shall be exercised in the performance of the engagement.

Standards of Fieldwork

1. The work shall be adequately planned and assistants, if any, shall be properly supervised.
2. Sufficient evidence shall be obtained to provide a reasonable basis for the conclusion that is expressed in the report.

Standards of Reporting

1. The report shall identify the assertion being reported on and state the character of the engagement.
2. The report shall state the practitioner's conclusion about whether the assertion is presented in conformity with the established or stated criteria against which it was measured.
3. The report shall state all of the practitioner's significant reservations about the engagement and the presentation of the assertion.
4. The report on an engagement to evaluate an assertion that has been prepared in conformity with agreed-upon criteria or on an engagement to apply agreed-upon procedures should contain a statement limiting its use to the parties who have agreed upon such criteria or procedures.

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STATEMENTS ON STANDARDS FOR ATTESTATION ENGAGEMENTS

These Statements are issued by the Auditing Standards Board, the Accounting and Review Services Committee, and the Management Consulting Services Executive Committee under the authority granted them by the Council of the Institute to interpret Rule 201, General Standards, and Rule 202, Compliance With Standards, of the Institute's Code of Professional Conduct. Members should be prepared to justify departures from this Statement.

Interpretations are issued by the Audit Issues Task Force of the Auditing Standards Board to provide timely guidance on the application of pronouncements of that Board. Interpretations are reviewed by the Auditing Standards Board. An interpretation is not as authoritative as a pronouncement of that Board, but members should be aware that they may have to justify a departure from an interpretation if the quality of their work is questioned.

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AT Section 100

Attestation Standards

Source: SSAE No. 1.

See section 9100 for interpretations of this section.

Effective for attest reports issued on or after September 30, 1986, unless otherwise indicated.

Attest Engagement

.01 When a certified public accountant in the practice of public accounting[1] (herein referred to as "a practitioner") performs an attest engagement, as defined below, the engagement is subject to the attestation standards and related interpretive commentary in this pronouncement and to any other authoritative interpretive standards that apply to the particular engagement.[2]

An attest engagement is one in which a practitioner is engaged to issue or does issue a written communication that expresses a conclusion about the reliability of a written assertion [3] that is the responsibility of another party.[4]

.02 Examples of professional services typically provided by practitioners that would not be considered attest engagements include—

a. Management consulting engagements in which the practitioner is engaged to provide advice or recommendations to a client.

b. Engagements in which the practitioner is engaged to advocate a client's position—for example, tax matters being reviewed by the Internal Revenue Service.

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[1] A "certified public accountant in the practice of public accounting" includes any of the following who perform or assist in the attest engagement: (1) an individual public accountant; (2) a proprietor, partner, or shareholder in a public accounting firm; (3) a full- or part-time employee of a public accounting firm; and (4) an entity (for example, partnership, corporation, trust, joint venture, or pool) whose operating, financial, or accounting policies can be significantly influenced by one of the persons described in (1) through (3) or by two or more of such persons if they choose to act together.

[2] Existing authoritative standards that might apply to a particular attest engagement include SASs, SSARSs, and Statement on Standards for Accountants' Services on Prospective Financial Information. In addition, authoritative interpretive standards for specific types of attest engagements, including standards concerning the subject matter of the assertions presented, may be issued in the future by authorized AICPA senior technical committees. Furthermore, when a practitioner undertakes an attest engagement for the benefit of a government body or agency and agrees to follow specified government standards, guides, procedures, statutes, rules, and regulations, the practitioner is obliged to follow this section and the applicable authoritative interpretive standards as well as those governmental requirements.

[3] An *assertion* is any declaration, or set of related declarations taken as a whole, by a party responsible for it.

[4] The term *attest* and its variants, such as *attesting* and *attestation,* are used in a number of state accountancy laws, and in regulations issued by State Boards of Accountancy under such laws, for different purposes and with different meanings from those intended by this section. Consequently, the definition of *attest engagement* set out in this paragraph, and the attendant meaning of *attest* and *attestation* as used throughout the section should not be understood as defining these terms, and similar terms, as they are used in any law or regulation, nor as embodying a common understanding of the terms which may also be reflected in such laws or regulations.

c. Tax engagements in which a practitioner is engaged to prepare tax returns or provide tax advice.

d. Engagements in which the practitioner compiles financial statements, because he is not required to examine or review any evidence supporting the information furnished by the client and does not express any conclusion on its reliability.

e. Engagements in which the practitioner's role is solely to assist the client—for example, acting as the company accountant in preparing information other than financial statements.

f. Engagements in which a practitioner is engaged to testify as an expert witness in accounting, auditing, taxation, or other matters, given certain stipulated facts.

g. Engagements in which a practitioner is engaged to provide an expert opinion on certain points of principle, such as the application of tax laws or accounting standards, given specific facts provided by another party so long as the expert opinion does not express a conclusion about the reliability of the facts provided by the other party.

.03 The practitioner who does not explicitly express a conclusion about the reliability of an assertion that is the responsibility of another party should be aware that there may be circumstances in which such a conclusion could be reasonably inferred. For example, if the practitioner issues a report that includes an enumeration of procedures that could reasonably be expected to provide assurance about an assertion, the practitioner may not be able to avoid the inference that the report is an attest report merely by omitting an explicit conclusion on the reliability of the assertion.

.04 The practitioner who has assembled or assisted in assembling an assertion should not claim to be the asserter if the assertion is materially dependent on the actions, plans, or assumptions of some other individual or group. In such a situation, that individual or group is the "asserter," and the practitioner will be viewed as an attester if a conclusion about the reliability of the assertion is expressed.

.05 An attest engagement may be part of a larger engagement—for example, a feasibility study or business acquisition study that includes an examination of prospective financial information. In such circumstances, these standards apply only to the attest portion of the engagement.

General Standards

.06 The first general standard is—*The engagement shall be performed by a practitioner or practitioners having adequate technical training and proficiency in the attest function.*

.07 Performing attest services is different from preparing and presenting an assertion. The latter involves collecting, classifying, summarizing, and communicating information; this usually entails reducing a mass of detailed data to a manageable and understandable form. On the other hand, performing attest services involves gathering evidence to support the assertion and objectively assessing the measurements and communications of the asserter. Thus, attest services are analytical, critical, investigative, and concerned with the basis and support for the assertions.

.08 The attainment of proficiency as an attester begins with formal education and extends into subsequent experience. To meet the requirements of a professional, the attester's training should be adequate in technical scope and should include a commensurate measure of general education.

.09 The second general standard is—*The engagement shall be performed by a practitioner or practitioners having adequate knowledge in the subject matter of the assertion.*

.10 A practitioner may obtain adequate knowledge of the subject matter to be reported on through formal or continuing education, including self-study, or through practical experience. However, this standard does not necessarily require a practitioner to personally acquire all of the necessary knowledge in the subject matter to be qualified to judge an assertion's reliability. This knowledge requirement may be met, in part, through the use of one or more specialists on a particular attest engagement if the practitioner has sufficient knowledge of the subject matter (a) to communicate to the specialist the objectives of the work and (b) to evaluate the specialist's work to determine if the objectives were achieved.

.11 The third general standard is—*The practitioner shall perform an engagement only if he or she has reason to believe that the following two conditions exist:*

a. *The assertion is capable of evaluation against reasonable criteria that either have been established by a recognized body or are stated in the presentation of the assertion in a sufficiently clear and comprehensive manner for a knowledgeable reader to be able to understand them.*

b. *The assertion is capable of reasonably consistent estimation or measurement using such criteria.*

.12 The attest function should be performed only when it can be effective and useful. Practitioners should have a reasonable basis for believing that a meaningful conclusion can be provided on an assertion.

.13 The first condition requires an assertion to have reasonable criteria against which it can be evaluated. Criteria promulgated by a body designated by Council under the AICPA Code of Professional Conduct are, by definition, considered to be reasonable criteria for this purpose. Criteria issued by regulatory agencies and other bodies composed of experts that follow due-process procedures, including procedures for broad distribution of proposed criteria for public comment, normally should also be considered reasonable criteria for this purpose.

.14 However, criteria established by industry associations or similar groups that do not follow due process or do not as clearly represent the public interest should be viewed more critically. Although established and recognized in some respects, such criteria should be considered similar to measurement and disclosure criteria that lack authoritative support, and the practitioner should evaluate whether they are reasonable. Such criteria should be stated in the presentation of the assertion in a sufficiently clear and comprehensive manner for knowledgeable readers to be able to understand them.

.15 Reasonable criteria are those that yield useful information. The usefulness of information depends on an appropriate balance between relevance and reliability. Consequently, in assessing the reasonableness of measurement and disclosure criteria, the practitioner should consider whether the assertions generated by such criteria have an appropriate balance of the following characteristics.

a. Relevance

- *Capacity to make a difference in a decision*—The assertions are useful in forming predictions about the outcomes of past, present, and future events or in confirming or correcting prior expectations.

- *Ability to bear upon uncertainty*—The assertions are useful in confirming or altering the degree of uncertainty about the result of a decision.
- *Timeliness*—The assertions are available to decision makers before they lose their capability to influence decisions.
- *Completeness*—The assertions do not omit information that could alter or confirm a decision.
- *Consistency*—The assertions are measured and presented in materially the same manner in succeeding time periods or (if material inconsistencies exist) changes are disclosed, justified, and, where practical, reconciled to permit proper interpretations of sequential measurements.

b. Reliability

- *Representational faithfulness*—The assertions correspond or agree with the phenomena they purport to represent.
- *Absence of unwarranted inference of certainty or precision*—The assertions may sometimes be presented more appropriately through the use of ranges or indications of the probabilities attaching to different values rather than as single point estimates.
- *Neutrality*—The primary concern is the relevance and reliability of the assertions rather than their potential effect on a particular interest.
- *Freedom from bias*—The measurements involved in the assertions are equally likely to fall on either side of what they represent rather than more often on one side than the other.

.16 Some criteria are reasonable in evaluating a presentation of assertions for only a limited number of specified users who participated in their establishment. For instance, criteria set forth in a purchase agreement for the preparation and presentation of financial statements of a company to be acquired, when materially different from generally accepted accounting principles (GAAP), are reasonable only when reporting to the parties to the agreement.

.17 Even when reasonable criteria exist, the practitioner should consider whether the assertion is also capable of reasonably consistent estimation or measurement using those criteria.[5] Competent persons using the same or similar measurement and disclosure criteria ordinarily should be able to obtain materially similar estimates or measurements. However, competent persons will not always reach the same conclusion because (a) such estimates and measurements often require the exercise of considerable professional judgment and (b) a slightly different evaluation of the facts could yield a significant difference in the presentation of a particular assertion. An assertion estimated or measured using criteria promulgated by a body designated by Council under the AICPA Code of Professional Conduct is considered, by definition, to be capable of reasonably consistent estimation or measurement.

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[5] Criteria may yield quantitative or qualitative estimates or measurement.

.18 A practitioner should not provide assurance on an assertion that is so subjective (for example, the "best" software product from among a large number of similar products) that people having competence in and using the same or similar measurement and disclosure criteria would not ordinarily be able to obtain materially similar estimates or measurements. A practitioner's assurance on such an assertion would add no real credibility to the assertion; consequently, it would be meaningless at best and could be misleading.

.19 The second condition does not presume that all competent persons would be expected to select the same measurement and disclosure criteria in developing a particular estimate or measurement (for example, the provision for depreciation on plant and equipment). However, assuming the same measurement and disclosure criteria were used (for example, the straight-line method of depreciation), materially similar estimates or measurements would be expected to be obtained.

.20 Furthermore, for the purpose of assessing whether particular measurement and disclosure criteria can be expected to yield reasonably consistent estimates or measurements, materiality must be judged in light of the expected range of reasonableness for a particular assertion. For instance, "soft" information, such as forecasts or projections, would be expected to have a wider range of reasonable estimates than "hard" data, such as the quantity of a particular item of inventory existing at a specific location.

.21 The second condition applies equally whether the practitioner has been engaged to perform an "examination" or a "review" of a presentation of assertions (see the second reporting standard). Consequently, it is inappropriate to perform a review engagement where the practitioner concludes that an examination cannot be performed because competent persons using the same or similar measurement and disclosure criteria would not ordinarily be able to obtain materially similar estimates or measurements. For example, practitioners should not provide negative assurance on the assertion that a particular software product is the "best" among a large number of similar products because they could not provide the highest level of assurance (a positive opinion) on such an assertion (were they engaged to do so) because of its inherent subjectivity.

.22 The fourth general standard is—*In all matters relating to the engagement, an independence in mental attitude shall be maintained by the practitioner or practitioners.*

.23 The practitioner should maintain the intellectual honesty and impartiality necessary to reach an unbiased conclusion about the reliability of an assertion. This is a cornerstone of the attest function. Consequently, practitioners performing an attest service should not only be independent in fact, but also should avoid situations that may impair the appearance of independence.

.24 In the final analysis, independence means objective consideration of facts, unbiased judgments, and honest neutrality on the part of the practitioner in forming and expressing conclusions. It implies not the attitude of a prosecutor but a judicial impartiality that recognizes an obligation for fairness. Independence presumes an undeviating concern for an unbiased conclusion about the reliability of an assertion no matter what the assertion may be.

.25 The fifth general standard is—*Due professional care shall be exercised in the performance of the engagement.*

.26 Due care imposes a responsibility on each practitioner involved with the engagement to observe each of the attestation standards. Exercise of due care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including the preparation of the report.

.27 *Cooley on Torts,* a treatise that has stood the test of time, describes a professional's obligation for due care as follows:

> Every man who offers his services to another and is employed, assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all those employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretentions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon mere errors of judgment.[6]

Standards of Fieldwork

.28 The first standard of fieldwork is—*The work shall be adequately planned and assistants, if any, shall be properly supervised.*

.29 Proper planning and supervision contribute to the effectiveness of attest procedures. Proper planning directly influences the selection of appropriate procedures and the timeliness of their application, and proper supervision helps ensure that planned procedures are appropriately applied.

.30 Planning an attest engagement involves developing an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, practitioners need to have sufficient knowledge to enable them to understand adequately the events, transactions, and practices that, in their judgment, have a significant effect on the presentation of the assertions.

.31 Factors to be considered by the practitioner in planning an attest engagement include (a) the presentation criteria to be used, (b) the anticipated level of attestation risk[7] related to the assertions on which he or she will report, (c) preliminary judgments about materiality levels for attest purposes, (d) the items within a presentation of assertions that are likely to require revision or adjustment, (e) conditions that may require extension or modification of attest procedures, and (f) the nature of the report expected to be issued.

.32 The nature, extent, and timing of planning will vary with the nature and complexity of the assertions and the practitioner's prior experience with the asserter. As part of the planning process, the practitioner should consider the nature, extent, and timing of the work to be performed to accomplish the objectives of the attest engagement. Nevertheless, as the attest engagement progresses, changed conditions may make it necessary to modify planned procedures.

.33 Supervision involves directing the efforts of assistants who participate in accomplishing the objectives of the attest engagement and determining whether those objectives were accomplished. Elements of supervision include instructing assistants, staying informed of significant problems encountered, reviewing the work performed, and dealing with differences of opinion among

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[6] D. Haggard, *Cooley on Torts,* 472 (4th ed., 1932).

[7] *Attestation risk* is the risk that the practitioner may unknowingly fail to appropriately modify his or her attest report on an assertion that is materially misstated. It consists of (a) the risk (consisting of inherent risk and control risk) that the assertion contains errors that could be material and (b) the risk that the practitioner will not detect such errors (detection risk).

personnel. The extent of supervision appropriate in a given instance depends on many factors, including the nature and complexity of the subject matter and the qualifications of the persons performing the work.

.34 Assistants should be informed of their responsibilities, including the objectives of the procedures that they are to perform and matters that may affect the nature, extent, and timing of such procedures. The practitioner with final responsibility for the engagement should direct assistants to bring to his or her attention significant questions raised during the attest engagement so that their significance may be assessed.

.35 The work performed by each assistant should be reviewed to determine if it was adequately performed and to evalute whether the results are consistent with the conclusions to be presented in the practitioner's report.

.36 The second standard of fieldwork is—*Sufficient evidence shall be obtained to provide a reasonable basis for the conclusion that is expressed in the report.*

.37 Selecting and applying procedures that will accumulate evidence that is sufficient in the circumstances to provide a reasonable basis for the level of assurance to be expressed in the attest report requires the careful exercise of professional judgment. A broad array of available procedures may be applied in an attest engagement. In establishing a proper combination of procedures to appropriately restrict attestation risk, the practitioner should consider the following presumptions, bearing in mind that they are not mutually exclusive and may be subject to important exceptions.

a. Evidence obtained from independent sources outside an entity provides greater assurance of an assertion's reliability than evidence secured solely from within the entity.

b. Information obtained from the independent attester's direct personal knowledge (such as through physical examination, observation, computation, operating tests, or inspection) is more persuasive than information obtained indirectly.

c. The more effective the internal control structure the more assurance it provides about the reliability of the assertions.

.38 Thus, in the hierarchy of available attest procedures, those that involve search and verification (for example, inspection, confirmation, or observation), particularly when using independent sources outside the entity, are generally more effective in reducing attestation risk than those involving internal inquiries and comparisons of internal information (for example, analytical procedures and discussions with individuals responsible for the assertion). On the other hand, the latter are generally less costly to apply.

.39 In an attest engagement designed to provide the highest level of assurance on an assertion (an "examination"), the practitioner's objective is to accumulate sufficient evidence to limit attestation risk to a level that is, in the practitioner's professional judgment, appropriately low for the high level of assurance that may be imparted by his or her report. In such an engagement, a practitioner should select from all available procedures—that is, procedures that assess inherent and control risk and restrict detection risk—any combination that can limit attestation risk to such an appropriately low level.

.40 In a limited assurance engagement (a "review"), the objective is to accumulate sufficient evidence to limit attestation risk to a moderate level. To accomplish this, the types of procedures performed generally are limited to inquiries and analytical procedures (rather than also including search and verification procedures).

.41 Nevertheless, there will be circumstances when inquiry and analytical procedures (a) cannot be performed, (b) are deemed less efficient than other procedures, or (c) yield evidence indicating that the assertion may be incomplete or inaccurate. In the first circumstance, the practitioner should perform other procedures that he or she believes can provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would have provided. In the second circumstance, the practitioner may perform other procedures that he or she believes would be more efficient to provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would provide. In the third circumstance, the practitioner should perform additional procedures.

.42 The extent to which attestation procedures will be performed should be based on the level of assurance to be provided and the practitioner's consideration of (a) the nature and materiality of the information to the presentation of assertions taken as a whole, (b) the likelihood of misstatements, (c) knowledge obtained during current and previous engagements, (d) the asserter's competence in the subject matter of the assertion, (e) the extent to which the information is affected by the asserter's judgment, and (f) inadequacies in the asserter's underlying data.

.43 This standard also covers engagements designed solely to meet the needs of specified users who have participated in establishing the nature and scope of the engagement. In connection with those engagements, the practitioner is required to perform only those procedures that have been designed or agreed to by such users. Specified users include persons and entities who have participated in establishing the nature and scope of the attest engagement either directly or through a designated representative (for example, a lawyer, lead underwriter, trustee, or supervisory government agency).

.44 The practitioner's procedures generally may be as limited or extensive as the specified users desire; however, mere reading of the assertions does not constitute a procedure sufficient to permit a practitioner to report on the results of applying agreed-upon procedures to a presentation of assertions.

Standards of Reporting

.45 The first standard of reporting is—*The report shall identify the assertion being reported on and state the character of the engagement.*

.46 The practitioner who accepts an attest engagement should issue a report on the assertions or withdraw from the attest engagement. When a report is issued, the assertions should be identified by referring to a separate presentation of assertions that is the responsibility of the asserter. The presentation of assertions should generally be bound with or accompany the practitioner's report. Because the asserter's responsibility for the assertions should be clear, it is ordinarily not sufficient merely to include the assertions in the practitioner's report.

.47 The statement of the character of an attest engagement that is designed to result in a general-distribution report includes two elements: (a) a description of the nature and scope of the work performed and (b) a reference to the professional standards governing the engagement. When the form of the statement is prescribed in authoritative interpretive standards (for example, an examination in accordance with GAAS), that form should be used in the practitioner's report. However, when no such interpretive standards exist, (1) the terms *examination* and *review* should be used to describe engagements to provide, respectively, the highest level and a moderate level of assurance, and (2) the reference to professional standards should be accomplished by referring to "standards established by the American Institute of Certified Public Accountants."

.48 The statement of the character of an attest engagement in which the practitioner applies agreed-upon procedures should refer to conformity with the arrangements made with the specified user(s). Such engagements are designed to accommodate the specific needs of the parties in interest and should be described by identifying the procedures agreed upon by such parties.

.49 The second standard of reporting is—*The report shall state the practitioner's conclusion about whether the assertion is presented in conformity with the established or stated criteria against which it was measured.*

.50 The practitioner should consider the concept of materiality in applying this standard. In expressing a conclusion on the conformity of a presentation of assertions with established or stated criteria, the practitioner should consider the omission or misstatement of an individual assertion to be material if the magnitude of the omission or misstatement—individually or when aggregated with other omissions or misstatements—is such that a reasonable person relying on the presentation of assertions would be influenced by the inclusion or correction of the individual assertion. The relative, rather than absolute, size of an omission or misstatement determines whether it is material in a given situation.

.51 General-distribution attest reports should be limited to two levels of assurance: one based on a reduction of attestation risk to an appropriately low level (an "examination") and the other based on a reduction of attestation risk to a moderate level (a "review").

.52 In an engagement to achieve the highest level of assurance (an "examination"), the practitioner's conclusion should be expressed in the form of a positive opinion. When attestation risk has been reduced only to a moderate level (a "review"), the conclusion should be expressed in the form of negative assurance.

Examination

.53 When expressing a positive opinion, the practitioner should clearly state whether, in his or her opinion, the presentation of assertions is presented in conformity with established or stated criteria. Reports expressing a positive opinion on a presentation of assertions taken as a whole, however, may be qualified or modified for some aspect of the presentation or the engagement (see the third reporting standard). In addition, such reports may emphasize certain matters relating to the attest engagement or the presentation of assertions.

.54 The following is an illustration of an examination report that expresses an unqualified opinion on a presentation of assertions, assuming that no specific report form has been prescribed in authoritative interpretive standards.

> We have examined the accompanying [*identify the presentation of assertions—for example, Statement of Investment Performance Statistics of XYZ Fund for the year ended December 31, 19X1*]. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.
>
> [*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the presentation of assertions.*]
>
> In our opinion, the [*identify the presentation of assertions—for example, Statement of Investment Performance Statistics*] referred to above presents

[*identify the assertion—for example, the investment performance of XYZ Fund for the year ended December 31, 19X1*] in conformity with [*identify established or stated criteria—for example, the measurement and disclosure criteria set forth in Note 1*].

.55 When the presentation of assertions has been prepared in conformity with specified criteria that have been agreed upon by the asserter and the user, the practitioner's report should also contain—

a. A statement of limitations on the use of the report because it is intended solely for specified parties (see the fourth reporting standard).

b. An indication, when applicable, that the presentation of assertions differs materially from that which would have been presented if criteria for the presentation of such assertions for general distribution had been followed in its preparation (for example, financial statements prepared in accordance with criteria specified in a contractual arrangement may differ materially from statements prepared in conformity with GAAP).

Review

.56 In providing negative assurance, the practitioner's conclusion should state whether any information came to the practitioner's attention on the basis of the work performed that indicates that the assertions are not presented in all material respects in conformity with established or stated criteria. (As discussed more fully in the commentary to the third reporting standard, if the assertions are not modified to correct for any such information that comes to the practitioner's attention, such information should be described in the practitioner's report.)

.57 A practitioner's negative assurance report may also comment on or emphasize certain matters relating to the attest engagement or the presentation of assertions. Furthermore, the practitioner's report should—

a. Indicate that the work performed was less in scope than an examination.

b. Disclaim a positive opinion on the assertions.

c. Contain the additional statements noted in paragraph .55 when the presentation of assertions has been prepared in conformity with specified criteria that have been agreed upon by the asserter and user(s).

.58 The following is an illustration of a review report that expresses negative assurance where no exceptions have been found, assuming that no specific report form has been prescribed in authoritative interpretive standards:

> We have reviewed the accompanying [*identify the presentation of assertions—for example, Statement of Investment Performance Statistics of XYZ Fund for the year ended December 31, 19X1*]. Our review was conducted in accordance with standards established by the American Institute of Certified Public Accountants.
>
> A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the [*identify the presentation of assertions—for example, Statement of Investment Performance Statistics*]. Accordingly, we do not express such an opinion.
>
> [*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the presentation of assertions.*]

Based on our review, nothing came to our attention that caused us to believe that the accompanying [*identify the presentation of assertions—for example, Statement of Investment Performance Statistics*] is not presented in conformity with [*identify the established or stated criteria—for example, the measurement and disclosure criteria set forth in Note 1*].

Agreed-Upon Procedures

.59 A practitioner's conclusion on the results of applying agreed-upon procedures to a presentation of assertions should be in the form of a summary of findings, negative assurance, or both. Furthermore, the practitioner's report should contain—[8]

a. A statement of limitations on the use of the report because it is intended solely for the use of specified parties (see the fourth reporting standard).

b. A summary or list of the specific procedures performed (or reference thereto) to notify the reader what the reported findings or negative assurance are based on.

.60 A practitioner's report on the application of agreed-upon procedures ordinarily should also indicate that the work performed was less in scope than an examination and disclaim a positive opinion on the assertions. Furthermore, when the presentation of assertions has been prepared in conformity with specified criteria that have been agreed upon by the asserter and user(s), the practitioner's report should, when applicable, contain an indication that the presentation of assertions differs materially from that which would have been presented if criteria for the presentation of such assertions for general distribution had been followed in its preparation.

.61 The level of assurance provided in a report on the application of agreed-upon procedures depends on the nature and scope of the practitioner's procedures as agreed upon with the specified parties to whom the report is restricted. Furthermore, such parties must understand that they take responsibility for the adequacy of the attest procedures (and, therefore, the amount of assurance provided) for their purposes.

.62 The following is an illustration of an agreed-upon procedures report where the procedures are enumerated rather than referred to and where both a summary of findings and negative assurance are included. Either the summary of findings, if no exceptions are found, or negative assurance could be omitted.

To ABC Inc. and XYZ Fund

We have applied the procedures enumerated below to the accompanying [*identify the presentation of assertions—for example, Statement of Investment Performance Statistics of XYZ Fund for the year ended December 31, 19X1*]. These procedures, which were agreed to by ABC Inc. and XYZ Fund, were performed solely to assist you in evaluating [*identify the assertion—for example, the investment performance of XYZ Fund*]. This report is intended solely for your information and should not be used by those who did not participate in determining the procedures.

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[8] Accountants should follow the guidance in AU section 634, *Letters for Underwriters and Certain Other Requesting Parties,* when requested to perform agreed-upon procedures on an assertion and report thereon in a letter for an underwriter.
Accountants, when issuing a letter under the guidance provided in AU section 634, may not issue any additional letters or reports, under this section or any other section, to the underwriter or other requesting party in connection with the offering or placement of securities in which the accountants comment on items for which commenting is otherwise precluded by AU section 634, such as square footage of facilities. [Footnote added, February 1993, by the issuance of Statement on Auditing Standards No. 72.]

[*Include paragraph to enumerate procedures and findings.*]

These agreed-upon procedures are substantially less in scope than an examination, the objective of which is the expression of an opinion on the [*identify the presentation of assertions—for example, Statement of Investment Performance Statistics*]. Accordingly, we do not express such an opinion.

Based on the application of the procedures referred to above, nothing came to our attention that caused us to believe that the accompanying [*identify the presentation of assertions—for example, Statement of Investment Performance Statistics*] is not presented in conformity with [*identify the established, stated, or agreed-upon criteria—for example, the measurement and disclosure criteria set forth in Note 1*]. Had we performed additional procedures or had we made an examination of the [*identify the presentation of assertions—for example, Statement of Investment Performance Statistics*], other matters might have come to our attention that would have been reported to you.

.63 The third standard of reporting is—*The report shall state all of the practitioner's significant reservations about the engagement and the presentation of the assertion.*

.64 "Reservations about the engagement" refers to any unresolved problem that the practitioner had in complying with the these attestation standards, interpretive standards, or the specific procedures agreed to by the specific user(s). The practitioner should not express an unqualified conclusion unless the engagement has been conducted in accordance with the attestation standards. Such standards will not have been complied with if the practitioner has been unable to apply all the procedures that he or she considers necessary in the circumstances or, when applicable, that have been agreed upon with the user(s).

.65 Restrictions on the scope of an engagement, whether imposed by the client or by such other circumstances as the timing of the work or the inability to obtain sufficient evidence, may require the practitioner to qualify the assurance provided, to disclaim any assurance, or to withdraw from the engagement. The reasons for a qualification or disclaimer should be described in the practitioner's report.

.66 The practitioner's decision to provide qualified assurance, to disclaim any assurance, or to withdraw because of a scope limitation depends on an assessment of the effect of the omitted procedure(s) on his or her ability to express assurance on the presentation of assertions. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question, by their significance to the presentation of assertions, and by whether the engagement is an examination or a review. If the potential effects relate to many assertions within a presentation of assertions or if the practitioner is performing a review, a disclaimer of assurance or withdrawal is more likely to be appropriate. When restrictions that significantly limit the scope of the engagement are imposed by the client, the practitioner generally should disclaim any assurance on the presentation of assertions or withdraw from the engagement.

.67 "Reservations about the presentation of assertions" refers to any unresolved reservation about the conformity of the presentation with established or stated criteria, including the adequacy of the disclosure of material matters. They can result in either a qualified or an adverse report depending on the materiality of the departure from the criteria against which the assertions were evaluated.

.68 Reservations about the presentation of assertions may relate to the measurement, form, arrangement, content, or underlying judgments and assumptions applicable to the presentation of assertions and its appended notes, including, for example, the terminology used, the amount of detail given, the classification of items, and the bases of amounts set forth. The practitioner considers whether a particular reservation should be the subject of a qualified report or adverse report given the circumstances and facts of which he or she is aware at the time.

.69 The fourth standard of reporting is—*The report on an engagement to evaluate an assertion that has been prepared in conformity with agreed-upon criteria or on an engagement to apply agreed-upon procedures should contain a statement limiting its use to the parties who have agreed upon such criteria or procedures.*

.70 Certain reports should be restricted to specified users who have participated in establishing either the criteria against which the assertions were evaluated (which are not deemed to be "reasonable" for general distribution—see the third general standard) or the nature and scope of the attest engagement. Such procedures or criteria can be agreed upon directly by the user or through a designated representative. Reports on such engagements should clearly indicate that they are intended solely for the use of the specified parties and may not be useful to others.

Attest Services Related to MAS Engagements*

Attest Services as Part of an MAS Engagement

.71 When a practitioner[9] provides an attest service (as defined in this section) as part of an MAS engagement, the Statements on Standards for Attestation Engagements[10] apply only to the attest service. Statements on Standards for Management Advisory Services (SSMASs) apply to the balance of the MAS engagement.[11] [New paragraph added, effective for attest reports issued on or after May 1, 1988, by SSAE, *Attest Services Related to MAS Engagements.*]

.72 When the practitioner determines that an attest service is to be provided as part of an MAS engagement, the practitioner should inform the client of the relevant differences between the two types of services and obtain concurrence that the attest service is to be performed in accordance with the appropriate professional requirements. The MAS engagement letter or an amendment should document the requirement to perform an attest service. The practitioner should take such actions because the professional requirements for an attest service differ from those for a management advisory service. [New paragraph added, effective for attest reports issued on or after May 1, 1988, by SSAE, *Attest Services Related to MAS Engagements.*]

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* The terminology in this section is based on Statements on Standards for Management Advisory Services. The SSMASs were superseded by Statement on Standards for Consulting Services No. 1, *Consulting Services: Definitions and Standards* (SSCS), effective for engagements accepted on or after January 1, 1992. This section has not been revised to reflect the conforming changes necessary due to the issuance of SSCS.

[9] *Practitioner* is defined in this section to include a proprietor, partner, or shareholder in a public accounting firm and any full- or part-time employee of a public accounting firm, whether certified or not. [Footnote renumbered by Statement on Auditing Standards No. 72, February 1993.]

[10] This refers to the SSAE *Attestation Standards* and subsequent statements in that series, as issued by the AICPA. [Footnote renumbered by Statement on Auditing Standards No. 72, February 1993.]

[11] This refers to SSMAS No. 1, *Definitions and Standards for MAS Practice,* and subsequent statements in that series, as issued by the AICPA. [Footnote renumbered by Statement on Auditing Standards No. 72, February 1993.]

.73 The practitioner should issue separate reports on the attest engagement and the MAS engagement and, if presented in a common binder, the report on the attest engagement or service should be clearly identified and segregated from the report on the MAS engagement. [New paragraph added, effective for attest reports issued on or after May 1, 1988, by SSAE, *Attest Services Related to MAS Engagements.*]

Assertions, Criteria, and Evidence

.74 An attest service may involve written assertions, evaluation criteria, or evidential matter developed during a concurrent or prior MAS engagement. A written assertion of another party developed with the practitioner's advice and assistance as the result of such an MAS engagement may be the subject of an attestation engagement, provided the assertion is dependent upon the actions, plans, or assumptions of that other party who is in a position to have an informed judgment about its accuracy. Criteria developed with the practitioner's assistance may be used to evaluate an assertion in an attest engagement, provided such criteria meet the requirements in this section. Relevant information obtained in the course of a concurrent or prior MAS engagement may be used as evidential matter in an attest engagement, provided the information satisfies the requirements of this section. [New paragraph added, effective for attest reports issued on or after May 1, 1988, by SSAE, *Attest Services Related to MAS Engagements.*]

Nonattest Evaluations of Written Assertions

.75 The evaluation of statements contained in a written assertion of another party when performing a management advisory service does not in and of itself constitute the performance of an attest service. For example, in the course of an engagement to help a client select a computer that meets the client's needs, the practitioner may evaluate written assertions from one or more vendors, performing some of the same procedures as required for an attest service. However, the MAS report will focus on whether the computer meets the client's needs, not on the reliability of the vendor's assertions. Also, the practitioner's study of the computer's suitability will not be limited to what is in the written assertions of the vendors. Some or all of the information provided in the vendors' written proposals, as well as other information, will be evaluated to recommend a system suitable to the client's needs. Such evaluations are necessary to enable the practitioner to achieve the purpose of the MAS engagement. [New paragraph added, effective for attest reports issued on or after May 1, 1988, by SSAE, *Attest Services Related to MAS Engagements.*]

Effective Date

.76 Paragraphs .01 through .70 are effective for attest reports issued on or after September 30, 1986. Earlier application is encouraged. Paragraphs .71 through .75 are effective for attest reports issued on or after May 1, 1988. [As amended, effective for attest reports issued on or after May 1, 1988, by Statement on Standards for Attestation Engagements, *Attest Services Related to MAS Engagements.* Formerly paragraph .71, number changed by the issuance of SSAE, *Attest Services Related to MAS Engagements.*]

This Appendix provides a historical analysis made as of March 1986. This Appendix has not been revised to reflect the new terminology from the issuance of Statements on Auditing Standards Nos. 53 through 72.

Appendix A

.77 Comparison of the Attestation Standards With Generally Accepted Auditing Standards

1. Two principal conceptual differences exist between the attestation standards and the ten existing GAAS. First, the attestation standards provide a framework for the attest function beyond historical financial statements. Accordingly, references to "financial statements" and "generally accepted accounting principles," which exist in GAAS, are omitted from the attestation standards. Second, as is apparent in the standards of fieldwork and reporting, the attestation standards accommodate the growing number of attest services in which the practitioner expresses assurances below the level that is expressed for the traditional audit ("positive opinion").

2. In addition to these two major differences, another conceptual difference exists. The attestation standards formally provide for attest services that are tailored to the needs of users who have participated in establishing either the nature and scope of the attest engagement or the specialized criteria against which the assertions are to be measured, and who will thus receive a limited-use report. Although these differences are substantive, they merely recognize changes that have already occurred in the marketplace and in the practice of public accounting.

3. As a consequence of these three conceptual differences, the composition of the attestation standards differs from that of GAAS. The compositional differences, as indicated in the table at the end of this Appendix, fall into two major categories: (a) two general standards not contained in GAAS are included in the attestation standards and (b) one of the fieldwork standards and two of the reporting standards in GAAS are not explicitly included in the attestation standards. Each of these differences is described in the remainder of this Appendix.

4. Two new general standards are included because, together with the definition of an attest engagement, they establish appropriate boundaries around the attest function. Once the subject matter of attestation extends beyond historical financial statements, there is a need to determine just how far this extension of attest services can and should go. The boundaries set by the attestation standards require (a) that the practitioner have adequate knowledge in the subject matter of the assertion (the second general standard) and (b) that the assertion be capable of reasonably consistent estimation or measurement using established or stated criteria (the third general standard).

5. The second standard of fieldwork in GAAS is not included in the attestation standards for a number of reasons. That standard calls for "a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted." The most important reason for not including this standard is that the second standard of fieldwork of the attestation standards encompasses the study and evaluation of internal controls because, when performed, it is an element of accumulating sufficient evidence. A second reason is that the concept of internal control may not be relevant for certain assertions (for example, aspects of information about computer software) on which a practitioner may be engaged to report.

6. The attestation standards of reporting are organized differently from the GAAS reporting standards to accommodate matters of emphasis that naturally evolve from an expansion of the attest function to cover more than one level and form of assurance on a variety of presentations of assertions. There is also a new reporting theme in the attestation standards. This is the limitation of the use of certain reports to specified users and is a natural extension of the acknowledgement that the attest function should accommodate engagements tailored to the needs of specified parties who have participated in establishing either the nature and scope of the engagement or the specified criteria against which the assertions were measured.

7. In addition, two reporting standards in GAAS have been omitted from the attestation standards. The first is the standard that requires the auditor's report to state "whether such [accounting] principles have been consistently observed in the current period in relation to the preceding period." The second states that "informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report." Those two standards are not included in the attestation standards because the second attestation standard of reporting, which requires a conclusion about whether the assertions are presented in conformity with established or stated criteria, encompasses both of these omitted standards.

Attestation Standards Compared With Generally Accepted Auditing Standards

Attestation Standards	*Generally Accepted Auditing Standards*
	General Standards
1. The engagement shall be performed by a practitioner or practitioners having adequate technical training and proficiency in the attest function.	1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. The engagement shall be performed by a practitioner or practitioners having adequate knowledge in the subject matter of the assertion.	
3. The practitioner shall perform an engagement only if he or she has reason to believe that the following two conditions exist: ● The assertion is capable of evaluation against reasonable criteria that either have been established by a recognized body or are stated in the presentation of the assertion in a sufficiently clear and comprehensive manner for a knowledgeable reader to be able to understand them. ● The assertion is capable of reasonably consistent estimation or measurement using such criteria.	
4. In all matters relating to the engagement, an independence in mental attitude shall be maintained by the practitioner or practitioners.	2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
5. Due professional care shall be exercised in the performance of the engagement.	3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.
	Standards of Fieldwork
1. The work shall be adequately planned and assistants, if any, shall be properly supervised.	1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
	2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

2. Sufficient evidence shall be obtained to provide a reasonable basis for the conclusion that is expressed in the report.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall identify the assertion being reported on and state the character of the engagement.
2. The report shall state the practitioner's conclusion about whether the assertion is presented in conformity with the established or stated criteria against which it was measured.
3. The report shall state all of the practitioner's significant reservations about the engagement and the presentation of the assertion.
4. The report on an engagement to evaluate an assertion that has been prepared in conformity with agreed-upon criteria or on an engagement to apply agreed-upon procedures should contain a statement limiting its use to the parties who have agreed upon such criteria or procedures.

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

[Formerly paragraph *.72*, number changed by the issuance of SSAE, *Attest Services Related to MAS Engagements*, effective for attest reports issued on or after May 1, 1988.]

This Appendix provides a historical analysis made as of March 1986. This Appendix has not been revised to reflect the new terminology from the issuance of Statements on Auditing Standards Nos. 53 through 72 or SSAE No. 2.

Appendix B

.78 Analysis of Apparent or Possible Inconsistencies Between the Attestation Standards and Existing SASs and SSARSs

1. There are no identified inconsistencies between the attestation standards and the ten generally accepted auditing standards or those SASs that deal with audits of historical financial statements. However, certain existing interpretive standards (SASs and SSARSs) and audit and accounting guides that pertain to other attest services are modestly inconsistent with these attestation standards. The purpose of this Appendix is to identify apparent or possible inconsistencies between the attestation standards and existing SASs and SSARSs. It provides appropriate standard-setting bodies with a list of matters that may require their attention. The Auditing Standards Board and the Accounting and Review Services Committee will evaluate apparent or possible inconsistencies and consider whether any changes are necessary. The decision to propose changes, if any, to existing pronouncements will be the subject of the regular due-process procedures of AICPA standard-setting bodies.

2. The specific SASs, SSARSs, and other pronouncements in which apparent or possible inconsistencies exist (in whole or in part) have been classified into the following broad categories to assist readers in understanding and evaluating their potential significance:

a. Exception reporting

b. Failure to report on conformity with established or stated criteria

c. Failure to refer to a separate presentation of assertions that is the responsibility of the asserter

d. Lack of appropriate scope of work for providing a moderate level of assurance

e. Report wording inconsistencies

All existing authoritative pronouncements will remain in force while the Auditing Standards Board and the Accounting and Review Services Committee evaluate these apparent or possible inconsistencies.

Exception Reporting

3. Certain SASs (Nos. 27, 28, 36, 40, and 45) require the auditor to apply certain limited procedures to supplementary information required by the Financial Accounting Standards Board (FASB) but to separately report on such information only if exceptions arise. The purpose of these limited procedures is to permit the auditor to reach a conclusion on the reliability of required supplementary information; consequently, this seems to amount to an attest service in the broadest sense of that term. However, because the auditor has not been engaged to express and normally does not express a conclusion in this particular circumstance, the limited procedures do not fully meet the definition of an attest engagement.

Failure to Report on Conformity With Established or Stated Criteria

4. SAS Nos. 29 and 42 provide guidance for auditors when they report on two specific types of assertions: information accompanying financial statements in an auditor-submitted document and condensed financial information, respectively. The apparent criterion against which the auditor is directed to report is whether the assertion is "fairly stated in all material respects in relation to the basic financial statements taken as a whole."

5. To some, such a form of reporting seems to be inconsistent with the second reporting standard, which requires the practitioner's report to state "whether the assertions are presented in conformity with the established or stated criteria against which they were measured." Although it seems reasonably clear that GAAP are the established criteria against which the information accompanying financial statements in an auditor-submitted document is evaluated, the report form required by SAS No. 29 does not specifically refer to GAAP. Such reference, if it were required, would effectively reduce the stated level of materiality from the "financial statements as a whole" to the specific assertions on which the practitioner is reporting, and a practitioner may not have obtained sufficient evidence to provide a positive opinion on the assertions in such a fashion.

6. The situation with respect to SAS No. 42 is somewhat different. Although some would argue that there are established criteria (for example, GAAP or Securities and Exchange Commission [SEC] regulations) for condensed financial statements and selected financial information, others do not agree with such a conclusion. The Auditing Standards Board took the latter position when this SAS was adopted because it did not provide for a reference to GAAP or SEC regulations in the standard auditor's report.

Failure to Refer to a Separate Presentation of Assertions That Is the Responsibility of the Asserter

7. SAS Nos. 14 and 30 provide for attest reports in which there is no reference to a separate presentation of assertions by the responsible party. In both cases, management's assertions—compliance with regulatory or contractual requirements and the adequacy of the entity's system of internal accounting control—are, at best, implied or contained in a management representation letter.

8. For instance, SAS No. 30 refers to an engagement to express an opinion on an entity's system of internal accounting control rather than on management's description of such a system (including its evaluation of the system's adequacy). Furthermore, the standard report gives the practitioner's opinion directly on the system. In an effort to better place the responsibility for the system where it really lies, the report does include some additional explanatory paragraphs that contain statements about management's responsibility and the inherent limitations of internal controls.

Lack of Appropriate Scope of Work for Providing a Moderate Level of Assurance

9. Portions of three SASs (SAS No. 14, on compliance with regulatory or contractual requirements; SAS No. 29, on information accompanying financial statements in an auditor-submitted document; and SAS No. 30, on a system of internal accounting control based on a financial statement audit) permit the expression of limited assurance on specific assertions based solely or substantially on those auditing procedures that happen to have been applied in forming an opinion on a separate assertion—the financial statements taken as a whole.

10. Such a basis for limited assurance seems inconsistent with the second fieldwork standard, which requires that limited assurance on a specific assertion must be based either on obtaining sufficient evidence to reduce

attestation risk to a moderate level as described in the attestation standards or applying specific procedures that have been agreed upon by specified users for their benefit. The scope of work performed on the specific assertions covered in the three SASs identified above depends entirely, or to a large extent, on what happens to be done in the audit of another assertion and would not seem to satisfy the requirements of either of the bases for limited assurance provided in the second standard of fieldwork.

11. Four other SASs (Nos. 27, 28, 40, and 45) may be inconsistent with the requirements of the second fieldwork standard in that they prescribe procedures as a basis for obtaining limited assurance on a specific assertion that seem to constitute a smaller scope than those necessary to reduce attestation risk to a moderate level. These SASs either limit the prescribed procedures to specific inquiries or the reading of an assertion, or they acknowledge that an auditor may not be able to perform inquiries to resolve doubts about certain assertions.

Report Wording Inconsistencies

12. The four reporting standards require that an attest report contain specific elements, such as an identification of the assertions, a statement of the character of the engagement, a disclaimer of positive opinion in limited assurance engagements, and the use of negative assurance wording in such engagements. A number of existing SASs and SSARSs prescribe reports that do not contain some of these elements.

13. Because a compilation of financial statements as described in the SSARSs and a compilation of prospective financial statements as described in the Statement on Standards for Accountants' Services on Prospective Financial Information [section 200] do not result in the expression of a conclusion on the reliability of the assertions contained in those financial statements, they are not attest engagements. Therefore, such engagements do not have to comply with the attestation standards and there can be no inconsistencies. Although it does not involve the attest function, a compilation is nevertheless a valuable professional service involving a practitioner's expertise in putting an entity's financial information into the form of financial statements—an accounting (subject matter) expertise rather than attestation expertise.

14. Certain existing reporting and other requirements of SASs and SSARSs go beyond (but are not contrary to) the standards. Examples include the requirements to perform a study and evaluation of internal control, to report on consistency in connection with an examination of financial statements, and to withdraw in a review of financial statements when there is a scope limitation. These requirements remain in force.

[Formerly paragraph .73, number changed by the issuance of SSAE, *Attest Services Related to MAS Engagements,* effective for attest reports issued on or after May 1, 1988.]

[The next page is 2541.]

AT Section 9100

Attestation Standards: Attestation Engagements Interpretations of Section 100

1. Defense Industry Questionnaire on Business Ethics and Conduct

.01 *Question*—Certain defense contractors have made a commitment to adopt and implement six principles of business ethics and conduct contained in the *Defense Industry Initiatives on Business Ethics and Conduct (Initiatives)*. One of those principles concerns defense contractors' public accountability for their commitment to the Initiatives. That principle requires completion of a *Questionnaire on Business Ethics and Conduct (Questionnaire)*, which is appended to the six principles.

.02 The public accountability principle also requires the defense contractor's independent public accountant or similar independent organization to express a conclusion about the responses to the *Questionnaire* and issue a report thereon for submission to the External Independent Organization of the Defense Industry (EIODI). (Appendixes C and D to this Interpretation [paragraphs .29 and .30] provide background information about the *Initiatives*, the six principles, and the required *Questionnaire*.)

.03 A defense contractor may request its independent public accountant (practitioner) to examine or review its responses to the *Questionnaire* for the purpose of expressing a conclusion about the appropriateness of those responses in a report prepared for general distribution. Would such an engagement be an attest engagement as defined in Statement on Standards for Attestation Engagements, *Attestation Standards* (SSAE) [section 100]?

.04 *Interpretation*—SSAE [section 100] defines an attest engagement as one in which a practitioner is engaged to issue or does issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party. The questions in the *Questionnaire* and the accompanying responses are written assertions of the defense contractor. When a practitioner is engaged by a defense contractor to express a written conclusion about the appropriateness of those responses, such an engagement involves a written conclusion about the reliability of an assertion that is the responsibility of the defense contractor. Consequently, SSAE [section 100] applies to such engagements.

.05 *Question*—Paragraph 11 of SSAE [section 100.11] specifies that a practitioner shall perform an attest engagement only if there are reasons to believe that "the assertion is capable of evaluation against reasonable criteria that either have been established by a recognized body or are stated in the presentation of the assertion in a sufficiently clear and comprehensive manner for a knowledgeable reader to be able to understand them." What are the criteria against which such assertions are to be evaluated and do such criteria provide a reasonable basis for the general distribution of the presentation of the assertions and a practitioner's report thereon?

.06 *Interpretation*—The criteria for evaluating the defense contractor's assertions are set forth in the *Initiatives* and *Questionnaire*. The reasonableness of those criteria must be evaluated by assessing whether the assertions they generate (the questions and responses in the *Questionnaire*) have an appropriate balance of the relevance and reliability characteristics discussed in paragraph 15 of SSAE [section 100.15].

.07 The criteria set forth in the *Initiatives* and *Questionnaire* will, when properly applied, generate assertions that have an appropriate balance of relevance and reliability. Consequently, such criteria provide a reasonable basis for the general distribution of the *Questionnaire* and responses and the practitioner's report thereon. Although the criteria provide a reasonable basis for general distribution of the practitioner's report, they have not been established by the type of recognized body contemplated in paragraph 13 of SSAE [section 100.13]. Consequently, as required by paragraph 14 of SSAE [section 100.14], the criteria must be stated in the presentation of assertions in a sufficiently clear and comprehensive manner for a knowledgeable reader to understand them. This requirement will be satisfied if the defense contractor attaches the *Initiatives* and *Questionnaire* to the presentation of the assertions.

.08 *Question*—What is the nature of the procedures that should be applied to the *Questionnaire* responses?

.09 *Interpretation*—The objective of the procedures performed in either an examination or review engagement is to obtain evidential matter that the defense contractor has designed and placed in operation policies and programs that conform with the criteria in the *Initiatives* and *Questionnaire* in a manner that supports the responses to the questions in the *Questionnaire* and that the policies and programs operated during the period covered by the defense contractor's assertion. The objective does not include providing assurance about whether the defense contractor's policies and programs operated effectively to ensure compliance with the defense contractor's code of business ethics and conduct on the part of individual employees or about whether the defense contractor and its employees have complied with federal procurement laws. In an examination, the evidential matter should be sufficient to limit the attestation risk for the assertions to a level that is appropriately low for the high degree of assurance imparted by an examination report. In a review, this evidential matter should be sufficient to limit the attestation risk to a moderate level.

.10 Examination procedures include obtaining evidential matter by reading relevant policies and programs, making inquiries of appropriate defense contractor personnel, inspecting documents and records, confirming defense contractor assertions with its employees or others, and observing activities. Illustrative examination procedures are presented in Appendix A [paragraph .27]. Review procedures are generally limited to reading relevant policies and procedures and making inquiries of appropriate defense contractor personnel. Illustrative review procedures are presented in Appendix E [paragraph .31]. When applying examination or review procedures, the practitioner should assess the appropriateness (including the comprehensiveness) of the policies and programs in meeting the criteria in the *Initiatives* and *Questionnaire*.

.11 A particular defense contractor's policies and programs may vary from those of other defense contractors. As a result, evidential matter obtained from the procedures performed cannot be evaluated solely on a quantitative basis. Consequently, it is not practicable to establish only quantitative guidelines for determining the nature or extent of the evidential matter that is necessary to provide the assurance required in either an examination or review. The qualitative aspects should also be considered.

.12 In an examination it will be necessary for a practitioner's procedures to go beyond reading relevant policies and programs and making inquiries of appropriate defense contractor personnel to determine whether the policies and programs that support a defense contractor's answers to specific questions in the *Questionnaire* operated during the period.

.13 In determining the nature, timing, and extent of examination or review procedures, the practitioner should consider information obtained in the performance of other services for the defense contractor, for example, the audit of the defense contractor's financial statements. For multi-location defense contractors, whether policies and programs operated during the period should be evaluated for both the defense contractor's headquarters and for selected defense contracting locations. The practitioner may consider using the work of the defense contractor's internal auditors. The guidance in AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* may be useful in that consideration.

.14 Examination procedures, and in some instances review procedures, may require access to information involving specific instances of actual or alleged noncompliance with laws. An inability to obtain access to such information because of restrictions imposed by a defense contractor (for example, to protect attorney-client privilege) may constitute a scope limitation. Paragraphs 63 through 66 of SSAE [section 100.63—.66] provide guidance in such situations. The practitioner should assess the effect of the inability to obtain access to such information on his or her ability to form a conclusion about whether the related policy or program operated during the period. If the defense contractor's reasons for not permitting access to the information are reasonable (for example, the information is the subject of litigation or a governmental investigation) and have been approved by an executive officer of the defense contractor, the occurrences of restricted access to information are few in number, and the practitioner has access to other information about that specific instance or about other instances that is sufficient to permit a conclusion to be formed about whether the related policy or program operated during the period, the practitioner ordinarily would conclude that it is not necessary to disclaim assurance.

.15 If the practitioner's scope of work has been restricted with respect to one or more questions, the practitioner should consider the implications of that restriction on the practitioner's ability to form a conclusion about other questions. In addition, as the nature or number of questions on which the defense contractor has imposed scope limitations increases in significance, the practitioner should consider whether to withdraw from the engagement.

.16 *Question*—What is the form of report that should be issued to meet the requirements of SSAE [section 100]?

.17 *Interpretation*—The standards of reporting in SSAE (paragraphs 45 through 70 [section 100.45—.70]) provide guidance about report content and wording and the circumstances that may require report modification. Appendix B and Appendix F [paragraphs .28 and .32] provide illustrative reports appropriate for various circumstances. Paragraph 46 [section 100.46] states that the practitioner's report should refer to a separate presentation of assertions that is the responsibility of the asserter. The completed *Questionnaire* constitutes the presentation of assertions that should be referred to in the practitioner's report. The defense contractor should prepare a statement to accompany the presentation of the completed *Questionnaire* that asserts that the responses to the *Questionnaire* are appropriately presented in conformity with the criteria. An illustrative defense contractor statement is also presented in Appendix B and Appendix F [paragraphs .28 and .32].

.18 The engagements addressed in this Interpretation do not include providing assurance about whether the defense contractor's policies and programs operated effectively to ensure compliance with the defense contractor's code of business ethics and conduct on the part of individual employees or about whether the defense contractor and its employees have complied with federal procurement laws. The practitioner's report should explicitly disclaim an opinion on the extent of such compliance.

.19 Because variations in individual performance and interpretation will affect the operation of the defense contractor's policies and programs during the period, adherence to all such policies and programs in every case may not be possible. In determining whether a reservation about a response in the *Questionnaire* is sufficiently significant to result in an opinion modified for an exception to that response, the practitioner should consider the nature, causes, patterns, and pervasiveness of the instances in which the policies and programs did not operate as designed and their implications for that response in the *Questionnaire.*

.20 When scope limitations have precluded the practitioner from forming an opinion on the responses to one or more questions, the practitioner's report should describe all such scope restrictions. If such a scope limitation was imposed by the defense contractor after the practitioner had begun performing procedures, that fact should be stated in the report.

.21 A defense contractor may request the practitioner to communicate to management, the board of directors, or one of its committees, either orally or in writing, conditions noted that do not constitute significant reservations about the answers to the *Questionnaire* but that might nevertheless be of value to management. Agreed-upon arrangements between the practitioner and the defense contractor to communicate conditions noted may include, for example, the reporting of matters of less significance than those contemplated by the criteria stated in the *Initiatives* and *Questionnaire,* the existence of conditions specified by the defense contractor, the results of further investigation of matters noted to identify underlying causes, or suggestions for improvements in various policies or programs. Under these arrangements, the practitioner may be requested to visit specific locations, assess the effectiveness of specific policies or programs, or undertake specific attestation procedures not otherwise planned. In addition, the practitioner is not precluded from communicating matters believed to be of value, even if no specific request has been made.

.22 *Question*—Will the defense contractor's responses to questions 19 and 20 meet the relevance and reliability criteria for reporting under the attestation standards?

.23 *Interpretation*—For the reasons described in paragraphs .06—.07 the criteria set forth in the amendment to Principle 1 of the *Initiatives* described above and questions 19 and 20 will, when properly applied, generate assertions that have an appropriate balance of relevance and reliability for purposes of providing a reasonable basis for the practitioner's report thereon. Further, the requirement that the presentation of assertions be stated in a sufficiently clear and comprehensive manner for a knowledgeable reader to understand them will be satisfied if the defense contractor attaches the *Initiatives,* as amended, and the *Questionnaire,* including questions 19 and 20, to the presentation of assertions.

.24 *Question*—What is the nature of the examination or review procedures that should be applied to the responses to questions 19 and 20 of the *Questionnaire?*

.25 *Interpretation*—Appendix A [paragraph .27] includes illustrative procedures for an engagement to examine the responses to questions 1 through 18 of the *Questionnaire*. In an examination engagement, the practitioner should consider applying the following procedures to the responses to questions 19 and 20:

19. Does the Company have a code of conduct provision or associated policy addressing marketing activities?

Read the Code or associated policy to determine whether it addresses the following marketing activities.

a. The gathering of competitive information and the engagement and use of consultants (whether engaged in bid and proposal activity, marketing, research and development, engineering, or other tasks).

b. A description of limitations on information which employees or consultants seek or receive.

20. Does the Company have a code of conduct provision or associated policy requiring that consultants are governed by, and oriented regarding, the Company's code of conduct and relevant associated policies?

a. Read the Code or associated policy to determine whether consultants engaged in marketing activities are governed by it.

b. Determine by inquiry of Company officials and/or by reading relevant documentation how the Company orients consultants engaged in marketing activities to the Code and relevant associated policies.

c. Obtain additional evidential matter, by positive confirmation of a selected number of consultants engaged in marketing activities or by other means, that the Company oriented such consultants to the Code and relevant associated policies.

.26 Appendix E [paragraph .31] includes illustrative procedures for an engagement to review the responses to questions 1 through 18 of the *Questionnaire*. In a review engagement, the practitioner should consider applying the following procedures to the responses to questions 19 and 20:

19. Does the Company have a code of conduct provision or associated policy addressing marketing activities?

Read the Code or associated policy to determine whether it addresses the following marketing activities:

a. The gathering of competitive information and the engagement and use of consultants (whether engaged in bid and proposal activity, marketing, research and development, engineering, or other tasks).

b. A description of limitations on information which employees or consultants seek or receive.

20. Does the Company have a code of conduct provision or associated policy requiring that consultants are governed by, and oriented regarding, the Company's code of conduct and relevant associated policies?

a. Read the Code or associated policy to determine whether consultants engaged in marketing activities are governed by it.

b. Determine by inquiry of Company officials and/or by reading relevant documentation how the Company orients consultants engaged in marketing activities to the Code and relevant associated policies.

Appendix A

.27 Illustrative Procedures for Examination of Answers to Questionnaire

Defense Industry Questionnaire on Business Ethics and Conduct

Before performing procedures, the practitioner should read the *Defense Industry Initiatives on Business Ethics and Conduct.*

1. Does the Company have a written Code of Business Ethics and Conduct?

   Determine whether the Company has a written Code of Business Ethics and Conduct.

2. Is the Code distributed to all employees principally involved in defense work?

   a. Determine by inquiry of Company officials and/or by reading relevant documentation how the Company distributes the Code to all employees principally involved in defense work.

   b. Obtain additional evidential matter, by positive confirmation of a selected number of employees or by other means, that the Code was distributed to employees principally involved in defense work.

3. Are new employees provided any orientation to the Code?

   a. Determine by inquiry of Company officials and/or by reading relevant documentation how the Company provides an orientation to the Code to new employees.

   b. Obtain additional evidential matter, by positive confirmation of a selected number of employees hired during the reporting period or by other means, that an orientation to the Code was provided at time of employment.

4. Does the Code assign responsibility to operating management and others for compliance with the Code?

   Read the Code to determine whether it includes (a) the assignment of responsibility for compliance with the Code to operating management and others, and (b) a statement of the standards that govern the conduct of all employees in their relationships to the Company.

5. Does the Company conduct employee training programs regarding the Code?

   a. Determine by inquiry of Company officials and/or by reading relevant documentation how the Company conducts training programs regarding the Code.

   b. Obtain additional evidential matter, by positive confirmation of a selected number of employees or by other means, that the Company conducted employee training programs regarding the Code for employees principally involved in defense work.

6. Does the Code address standards that govern the conduct of employees in their dealings with suppliers, consultants and customers?

Read the Code to determine whether it addresses standards that govern the conduct of employees in their dealings with suppliers, consultants, and customers.

7. Is there a corporate review board, ombudsman, corporate compliance or ethics office or similar mechanism for employees to report suspected violations to someone other than their direct supervisor, if necessary?

   Determine by inquiry of Company officials, observation, and/or by reading relevant documentation whether a corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism exists for employees to report suspected violations.

8. Does the mechanism employed protect the confidentiality of employee reports?
   a. Determine by inquiry of members of the corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism established by the Company whether they understand the need to protect the confidentiality of employee reports.
   b. Determine by inquiry of Company officials and/or by reading relevant documentation how the procedures employed protect this confidentiality.

9. Is there an appropriate mechanism to follow-up on reports of suspected violations to determine what occurred, who was responsible, and recommended corrective and other actions?
   a. Determine by inquiry of Company officials and/or by reading relevant documentation how the follow-up procedures established by the Company operate and whether an appropriate mechanism exists to follow-up on reports of suspected violations reported to a corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism to determine what occurred, who was responsible, and recommended corrective and other action.
   b. Determine by inquiry of those responsible for performing such follow-up procedures how they document that the procedures were carried out.
   c. Obtain additional evidential matter that the follow-up mechanism was employed by examining a selected number of reports of suspected violations from the log or other record of reports used by the corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism.

10. Is there an appropriate mechanism for letting employees know the result of any follow-up into their reported charges?
    a. Determine by inquiry of Company officials and/or by reading relevant documentation whether an appropriate mechanism exists for letting employees know the result of any follow-up into their reported charges.
    b. For those items selected at Question 9 above, determine by inquiry of members of the corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism and

by examining other evidential matter whether the results of the Company's follow-up of reported charges have been communicated to employees.

11. Is there an ongoing program of communication to employees, spelling out and re-emphasizing their obligations under the Code of conduct?

and

12. What are the specifics of such a program?
    A. Written communication?
    B. One-on-one communication?
    C. Group meetings?
    D. Visual aids?
    E. Others?
        a. Determine by inquiry of Company officials and/or by reading relevant documentation the extent of the Company's ongoing program of communication to employees, spelling out and re-emphasizing their obligations under the Code. Note the specific means of communication and compare to the Company's response to Question 12 of the *Questionnaire*.
        b. Read announcements and other evidential matter in support of the actual program of re-emphasis.

13. Does the Company have a procedure for voluntarily reporting violations of federal procurement laws to appropriate governmental agencies?

    Determine by inquiry of Company officials and/or by reading relevant documentation how the Company's procedures operate for determining whether violations of federal procurement laws are to be reported to appropriate governmental agencies and examine evidential matter to determine whether such procedures are being implemented.

14. Is implementation of the Code's provisions one of the standards by which all levels of supervision are expected to be measured in their performance?
    a. Determine by inquiry of Company officials and/or by reading relevant documentation, such as position descriptions and personnel policies, whether performance evaluations are to consider supervisors' efforts in the implementation of the Code's provisions as a standard of measurement of their performance.
    b. Obtain additional evidential matter to determine that supervisors are responsible for implementation of the Code's provisions.

15. Is there a program to monitor on a continuing basis adherence to the Code of conduct and compliance with federal procurement laws?
    a. Determine by inquiry of Company officials and/or by reading relevant documentation how the Company monitors, on a continuing basis, adherence to the Code and compliance with federal procurement laws.

b. Obtain additional evidential matter, for example by reading internal audit reports, of the Company's monitoring of compliance with the Code and federal procurement laws.

16. Does the Company participate in the industry's "Best Practices Forum"?

    Examine evidence of the Company's participation in the "Best Practices Forum."

17. Are periodic reports on adherence to the principles made to the Company's board of directors or to its audit or other appropriate committee?

    Determine by inquiry of Company officials and/or by reading minutes of the board of directors or audit or other appropriate committee meetings or other relevant documentation whether Company officials have reported on adherence to the principles of business ethics and conduct.

18. Are the Company's independent public accountants or a similar independent organization required to comment to the board of directors or a committee thereof on the efficacy of the Company's internal procedures for implementing the Company's Code of conduct?

    Determine by inquiry of Company officials and/or by reading relevant documentation whether the Company's independent accountants or a similar independent organization are required to comment to the board of directors or a committee thereof on the efficacy of the Company's internal procedures for implementing the Company's Code.

19. Does the Company have a code of conduct provision or associated policy addressing marketing activities?

    Read the Code or associated policy to determine whether it addresses the following marketing activities.

    a. The gathering of competitive information and the engagement and use of consultants (whether engaged in bid and proposal activity, marketing, research and development, engineering, or other tasks).

    b. A description of limitations on information which employees or consultants seek or receive.

20. Does the Company have a code of conduct provision or associated policy requiring that consultants are governed by, and oriented regarding, the Company's code of conduct and relevant associated policies?

    a. Read the Code or associated policy to determine whether consultants engaged in marketing activities are governed by it.

    b. Determine by inquiry of Company officials and/or by reading relevant documentation how the Company orients consultants engaged in marketing activities to the Code and relevant associated policies.

    c. Obtain additional evidential matter, by positive confirmation of a selected number of consultants engaged in marketing activities or by other means, that the Company oriented such consultants to the Code and relevant associated policies.

Appendix B

.28 Illustrative Defense Contractor Assertions and Examination Reports

Defense Industry Questionnaire on Business Ethics and Conduct

Illustration 1: Unqualified Opinion

Defense Contractor Assertion

Statement of Responses to the Defense Industry Questionnaire on *Business Ethics and Conduct for the period from ________ to ________.*

The affirmative responses in the accompanying *Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from ________ to ________* are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct,* including the Questionnaire.

Attachments:

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from ________ to ________.

Examination Report

To the Board of Directors of the XYZ Company

We have examined the XYZ Company's *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from ________ to ________*, and the Questionnaire and responses attached thereto. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. Those procedures were designed to evaluate whether the XYZ Company had policies and programs in operation during that period that support the affirmative responses to the *Questionnaire*. The procedures were not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's *Code of Business Ethics and Conduct* on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon.

In our opinion, the affirmative responses in the Questionnaire accompanying the *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from ________ to ________* referred to above are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct,* including the Questionnaire.

Illustration 2: Unqualified Opinion; Report Modified for Negative Responses

Defense Contractor Assertion

Statement of Responses to the Defense Industry Questionnaire on *Business Ethics and Conduct for the period from ________ to ________.*

The affirmative responses in the accompanying *Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from ________ to ________* are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct,* including the Questionnaire.

Attachments

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from ________ to ________.

(The responses could include an explanation of negative responses if the defense contractor so desired.)

Examination Report

To the Board of Directors of the XYZ Company

We have examined the XYZ Company's *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from ________ to ________,* and the Questionnaire and responses attached thereto. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. Those procedures were designed to evaluate whether the XYZ Company had policies and programs in operation during that period that support the affirmative responses to the *Questionnaire.* The procedures were not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's *Code of Business Ethics and Conduct* on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon.

In our opinion, the affirmative responses in the Questionnaire accompanying the *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from ________ to ________* referred to above are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct,* including the Questionnaire. The negative responses to Questions ________ and ________ in the Questionnaire indicate that the Company did not have policies and programs in operation during the period with respect to those areas.

Illustration 3: Opinion Modified for Exception on Certain Response

Defense Contractor Assertion

Statement of Responses to the Defense Industry Questionnaire on *Business Ethics and Conduct for the period from ________ to ________.*

The affirmative responses in the accompanying Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from ________ to ________ are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct,* including the Questionnaire.

Attachments:

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from ________ to ________.

Examination Report

To the Board of Directors of the XYZ Company

We have examined the XYZ Company's *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from ________ to ________*, and the Questionnaire and responses attached thereto. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. Those procedures were designed to evaluate whether the XYZ Company had policies and programs in operation during that period that support the affirmative responses to the Questionnaire. The procedures were not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's Code of Business Ethics and Conduct on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon.

In our opinion, except for the response to Question 10 as discussed in the following paragraph, the affirmative responses in the Questionnaire accompanying the *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from ________ to ________* referred to above are appropriately presented in conformity with the criteria set forth in the Defense Industry Initiatives on Business Ethics and Conduct, including the Questionnaire.

Management believes that an appropriate mechanism exists for informing employees of the results of the Company's follow-up into charges of violations of the Company's Code of Business Ethics and Conduct, and has accordingly answered Question 10 in the affirmative. That mechanism consists principally of distributing newspaper articles and press releases of violations of federal procurement laws that have been voluntarily reported to the appropriate governmental agencies. We do not believe that such a mechanism is sufficient, in as much as it does not provide follow-up information on violations reported by employees that are not deemed reportable to a governmental agency. Consequently, in our opinion, the affirmative response to Question 10 in the Questionnaire is not appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

Illustration 4: Opinion Modified for Exception on Certain Response; Report also Modified for Negative Responses

Defense Contractor Assertion

Statement of Responses to the *Defense Industry Questionnaire on Business Ethics and Conduct for the period from ________ to ________*.

The affirmative responses in the accompanying *Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from ________ to ________* are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

Attachments:

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from ________ to ________.

(The responses could include an explanation of negative responses if the defense contractor so desired.)

Examination Report

To the Board of Directors of the XYZ Company

We have examined the XYZ Company's *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from ________ to ________*, and the Questionnaire and responses attached thereto. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. Those procedures were designed to evaluate whether the XYZ Company had policies and programs in operation during that period that support the affirmative responses to the *Questionnaire*. The procedures were not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's *Code of Business Ethics and Conduct* on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon.

In our opinion, except for the response to Question 10 as discussed in the following paragraph, the affirmative responses in the Questionnaire accompanying the *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from ________ to ________* referred to above are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire. The negative responses to Questions ________ and ________ in the Questionnaire indicate that the Company did not have policies and programs in operation during the period with respect to those areas.

Management believes that an appropriate mechanism exists for informing employees of the results of the Company's follow-up into charges of violations of the Company's Code of Business Ethics and Conduct, and has accordingly answered Question 10 in the affirmative. That mechanism consists principally of distributing newspaper articles and press releases of violations of federal procurement laws that have been voluntarily reported to the appropriate governmental agencies. We do not believe that such a mechanism is sufficient, in as much as it does not provide follow-up information on violations reported by employees that are not deemed reportable to a governmental agency. Consequently, in our opinion, the affirmative response to Question 10 in the Questionnaire is not appropriately presented in conformity with the criteria set forth in the Defense Industry Initiatives on Business Ethics and Conduct, including the Questionnaire.

Illustration 5: Opinion Disclaimed on Certain Responses Because of Scope Restrictions Imposed by Client

Defense Contractor Assertion

Statement of Responses to the Defense Industry Questionnaire on *Business Ethics and Conduct for the period from ________ to ________.*

The affirmative responses in the accompanying *Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from ________ to ________* are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct,* including the Questionnaire.

Attachments:

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from ________ to ________.

Examination Report

To the Board of Directors of the XYZ Company

We have examined the XYZ Company's *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from ________ to ________*, and the Questionnaire and responses attached thereto. Except as explained in the following paragraph, our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. Those procedures were designed to evaluate whether the XYZ Company had policies and programs in operation during that period that support the affirmative responses to the *Questionnaire.* The procedures were not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's *Code of Business Ethics and Conduct* on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon.

We were not permitted to read relevant documents and files or interview appropriate employees to determine that the affirmative answers to Questions 8, 9, and 10 are appropriate. The nature of those questions precluded us from satisfying ourselves as to the appropriateness of those answers by means of other examination procedures.

In our opinion, the affirmative responses to Questions 1 through 7 and 11 through 18 in the Questionnaire accompanying the *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from ________ to ________* referred to above are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct,* including the Questionnaire. Because of the matters discussed in the preceding paragraph, the scope of our work was not sufficient to express, and we do not express, an opinion on the appropriateness of the affirmative responses to Questions 8, 9, and 10 in the Questionnaire.

Appendix C

.29 Background

Defense Industry Questionnaire on Business Ethics and Conduct

The June 1986 final report to the President of the United States, *A Quest for Excellence,* by the President's Blue Ribbon Commission on Defense Management (the "Packard Commission") included as an appendix the *Defense Industry Initiatives on Business Ethics and Conduct (Initiatives)* written by leaders in the defense industry and signed by many of the country's major defense contractors. The *Initiatives,* which were endorsed by the Packard Commission, set forth six principles of business ethics and conduct, which signatories to the *Initiatives* are committed to adopt and implement.

The sixth principle of business ethics and conduct specifies that "Each company must have public accountability for its commitment to these principles." The section of the *Initiatives* on implementation contains the following discussion of the sixth principle:

> The mechanism for public accountability will require each company to have its independent public accountants or similar independent organization complete and submit annually the attached questionnaire to an external independent body which will report the results for the industry as a whole and release the data simultaneously to the companies and the general public.
>
> This annual review, which will be conducted for the next three years, is a critical element giving force to these principles and adding integrity to this defense industry initiative as a whole. Ethical accountability, as a good-faith process, should not be affirmed behind closed doors. The defense industry is confronted with a problem of public perception—a loss of confidence in its integrity—that must be addressed publicly if the results are to be both real and credible, to the government and public alike. It is in this spirit of public accountability that this initiative has been adopted and these principles have been established.

Appendix D to this Interpretation [paragraph .30] reproduces in full the *Initiatives,* including the *Questionnaire on Business Ethics and Conduct (Questionnaire).*

Representatives of the signatories to the *Initiatives* have agreed that the defense contractor assertion illustrated in Appendix B and Appendix F [paragraphs .28 and .32], with the attachments thereto, is the appropriate vehicle for meeting the sixth principle referred to above. They also have agreed that each signatory should adopt and implement a code of business ethics and conduct that, in a self-contained document, addresses all of the required provisions of the six principles. In 1987, representatives of the signatories to the Initiatives created the External Independent Organization of the Defense Industry (EIODI) as the body to receive responses to the Questionnaire, report the results for the defense industry as a whole, and release the data to the companies and the public. The Auditing Standards Division of the American Institute of Certified Public Accountants, the EIODI, and representatives of the signatories to the *Initiatives* have agreed to a framework, which is embodied in this Interpretation, in which practitioners can accept engagements to attest to the answers to the *Questionnaire* and issue reports on the results of those engagements.

Appendix D

.30 Defense Industry Initiatives on Business Ethics and Conduct and Questionnaire on Business Ethics and Conduct *

Business Ethics and Conduct

The defense industry companies who sign this document already have, or commit to adopt and implement, a set of principles of business ethics and conduct that acknowledge and address their corporate responsibilities under federal procurement laws and to the public. Further, they accept the responsibility to create an environment in which compliance with federal procurement laws and free, open, and timely reporting of violations become the felt responsibility of every employee in the defense industry.

In addition to adopting and adhering to this set of six principles of business ethics and conduct, we will take the leadership in making the principles a standard for the entire defense industry.

I. Principles

1. Each company will have and adhere to a written code of business ethics and conduct.
2. The company's code establishes the high values expected of its employees and the standard by which they must judge their own conduct and that of their organization; each company will train its employees concerning their personal responsibilities under the code.
3. Each company will create a free and open atmosphere that allows and encourages employees to report violations of its code to the company without fear of retribution for such reporting.
4. Each company has the obligation to self-govern by monitoring compliance with federal procurement laws and adopting procedures for voluntary disclosure of violations of federal procurement laws and corrective actions taken.
5. Each company has a responsibility to each of the other companies in the industry to live by standards of conduct that preserve the integrity of the defense industry.
6. Each company must have public accountability for its commitment to these principles.

II. Implementation: Supporting Programs

While all companies pledge to abide by the six principles, each company agrees that it has implemented or will implement policies and programs to meet its management needs.

Principle 1: Written Code of Business Ethics and Conduct

A company's code of business ethics and conduct should embody the values that it and its employees hold most important; it is the highest expression of a corporation's culture. For a defense contractor, the code represents the commitment of the company and its employees to work for its customers, shareholders, *and* the nation.

* From *A Quest for Excellence,* appendix, final report by the President's Blue Ribbon Commission on Defense Management, June 1986.

It is important, therefore, that a defense contractor's written code explicitly address that higher commitment. It must also include a statement of the standards that govern the conduct of all employees in their relationships to the company, as well as in their dealings with customers, suppliers, and consultants. The statement also must include an explanation of the consequences of violating those standards, and a clear assignment of responsibility to operating management and others for monitoring and enforcing the standards throughout the company.

Defense industry marketing practices, including the gathering of competitive information and the engagement and use of consultants (whether engaged in bid and proposal activity, marketing, research and development, engineering, or other tasks), should be explicitly addressed. There should be a description of limitations on information which employees or consultants seek or receive. Where consultants are engaged, the company's code of conduct or policies should require that the consultants are governed by, and oriented regarding, the company's code of conduct and relevant associated policies.

Principle 2: Employees' Ethical Responsibilities

A company's code of business ethics and conduct should embody the basic values and culture of a company and should become a way of life, a form of honor system, for every employee. Only if the code is embodied in some form of honor system does it become more than mere words or abstract ideals. Adherence to the code becomes a responsibility of each employee both to the company and to fellow employees. Failure to live by the code, or to report infractions, erodes the trust essential to personal accountability and an effective corporate business ethics system.

Codes of business ethics and conduct are effective only if they are fully understood by every employee. Communications and training are critical to preparing employees to meet their ethical responsibilities. Companies can use a wide variety of methods to communicate their codes and policies and to educate their employees as to how to fulfill their obligations. Whatever methods are used—broad distribution of written codes, personnel orientation programs, group meetings, videotapes, and articles—it is critical that they ensure total coverage.

Principle 3: Corporate Responsibility to Employees

Every company must ensure that employees have the opportunity to fulfill their responsibility to preserve the integrity of the code and their honor system. Employees should be free to report suspected violations of the code to the company without fear of retribution for such reporting.

To encourage the surfacing of problems, normal management channels should be supplemented by a confidential reporting mechanism.

It is critical that companies create and maintain an environment of openness where disclosures are accepted and expected. Employees must believe that to raise a concern or report misconduct is expected, accepted, and protected behavior, not the exception. This removes any legitimate rationale for employees to delay reporting alleged violations or for former employees to allege past offenses by former employers or associates.

To receive and investigate employee allegations of violations of the corporate code of business ethics and conduct, defense contractors can use a contract review board, an ombudsman, a corporate ethics or compliance office or other similar mechanism.

In general, the companies accept the broadest responsibility to create an environment in which free, open and timely reporting of any suspected violations becomes the felt responsibility of every employee.

Principle 4: Corporate Responsibility to the Government

It is the responsibility of each company to aggressively self-govern and monitor adherence to its code and to federal procurement laws. Procedures will be established by each company for voluntarily reporting to appropriate government authorities violations of federal procurement laws and corrective actions.

In the past, major importance has been placed on whether internal company monitoring has uncovered deficiencies before discovery by governmental audit. The process will be more effective if all monitoring efforts are viewed as mutually reinforcing and the measure of performance is a timely and constructive surfacing of issues.

Corporate and government audit and control mechanisms should be used to identify and correct problems. Government and industry share this responsibility and must work together cooperatively and constructively to ensure compliance with federal procurement laws and to clarify any ambiguities that exist.

Principle 5: Corporate Responsibility to the Defense Industry

Each company must understand that rigorous self-governance is the foundation of these principles of business ethics and conduct and of the public's perception of the integrity of the defense industry.

Since methods of accountability can be improved through shared experience and adaptation, companies will participate in an annual intercompany "Best Practices Forum" that will bring together operating and staff managers from across the industry to discuss ways to implement the industry's principles of accountability.

Each company's compliance with the principles will be reviewed by a Board of Directors committee comprised of outside directors.

Principle 6: Public Accountability

The mechanism for public accountability will require each company to have its independent public accountants or similar independent organization complete and submit annually the attached questionnaire to an external independent body which will report the results for the industry as a whole and release the data simultaneously to the companies and the general public.

This annual review, which will be conducted for the next three years, is a critical element giving force to these principles and adding integrity to this defense industry initiative as a whole. Ethical accountability, as a good-faith process, should not be affirmed behind closed doors. The defense industry is confronted with a problem of public perception—a loss of confidence in its integrity—that must be addressed publicly if the results are to be both real and credible, to the government and public alike. It is in this spirit of public accountability that this initiative has been adopted and these principles have been established.

Questionnaire

1. Does the company have a written code of business ethics and conduct?
2. Is the code distributed to all employees principally involved in defense work?

3. Are new employees provided any orientation to the code?
4. Does the code assign responsibility to operating management and others for compliance with the code?
5. Does the company conduct employee training programs regarding the code?
6. Does the code address standards that govern the conduct of employees in their dealings with suppliers, consultants and customers?
7. Is there a corporate review board, ombudsman, corporate compliance or ethics office or similar mechanism for employees to report suspected violations to someone other than their direct supervisor, if necessary?
8. Does the mechanism employed protect the confidentiality of employee reports?
9. Is there an appropriate mechanism to follow-up on reports of suspected violations to determine what occurred, who was responsible, and recommended corrective and other actions?
10. Is there an appropriate mechanism for letting employees know the result of any follow-up into their reported charges?
11. Is there an ongoing program of communication to employees, spelling out and re-emphasizing their obligations under the code of conduct?
12. What are the specifics of such a program?
    a. Written communication?
    b. One-on-one communication?
    c. Group meetings?
    d. Visual aids?
    e. Others?
13. Does the company have a procedure for voluntarily reporting violations of federal procurement laws to appropriate governmental agencies?
14. Is implementation of the code's provisions one of the standards by which all levels of supervision are expected to be measured in their performance?
15. Is there a program to monitor on a continuing basis adherence to the code of conduct and compliance with federal procurement laws?
16. Does the company participate in the industry's "Best Practices Forum"?
17. Are periodic reports on adherence to the principles made to the company's Board of Directors or to its audit or other appropriate committee?
18. Are the company's independent public accountants or a similar independent organization required to comment to the Board of Directors or a committee thereof on the efficacy of the company's internal procedures for implementing the company's code of conduct?
19. Does the Company have a code of conduct provision or associated policy addressing marketing activities?
20. Does the Company have a code of conduct provision or associated policy requiring that consultants are governed by, and oriented

regarding, the Company's code of conduct and relevant associated policies?

Signatories to the *Initiatives* are required to initially respond to questions 19 and 20 in the *Questionnaire* for the reporting year ending September 30, 1989. The responses to questions 19 and 20 should cover at least the period from July 1, 1989 through September 30, 1989.

Appendix E

.31 Illustrative Procedures for Review of Answers to Questionnaire

Defense Industry Questionnaire on Business Ethics and Conduct

Before performing procedures, the practitioner should read the *Defense Industry Initiatives on Business Ethics and Conduct.*

1. Does the Company have a written Code of Business Ethics and Conduct?

   Determine whether the Company has a written Code of Business Ethics and Conduct.

2. Is the Code distributed to all employees principally involved in defense work?

   Determine by inquiry of Company officials and/or by reading relevant documentation how the Company distributes the Code to all employees principally involved in defense work.

3. Are new employees provided any orientation to the Code?

   Determine by inquiry of Company officials and/or by reading relevant documentation how the Company provides an orientation to the Code to new employees.

4. Does the Code assign responsibility to operating management and others for compliance with the Code?

   Read the Code to determine whether it includes (a) the assignment of responsibility for compliance with the Code to operating management and others, and (b) a statement of the standards that govern the conduct of all employees in their relationships to the Company.

5. Does the Company conduct employee training programs regarding the Code?

   Determine by inquiry of Company officials and/or by reading relevant documentation how the Company conducts training programs regarding the Code.

6. Does the Code address standards that govern the conduct of employees in their dealings with suppliers, consultants and customers?

   Read the Code to determine whether it addresses standards that govern the conduct of employees in their dealings with suppliers, consultants, and customers.

7. Is there a corporate review board, ombudsman, corporate compliance or ethics office or similar mechanism for employees to report suspected violations to someone other than their direct supervisor, if necessary?

   Determine by inquiry of Company officials and/or by reading relevant documentation whether a corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism exists for employees to report suspected violations.

8. Does the mechanism employed protect the confidentiality of employee reports?

a. Determine by inquiry of members of the corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism established by the Company whether they understand the need to protect the confidentiality of employee reports.
b. Determine by inquiry of Company officials and/or by reading relevant documentation how the procedures employed protect this confidentiality.

9. Is there an appropriate mechanism to follow-up on reports of suspected violations to determine what occurred, who was responsible, and recommended corrective and other actions?

Determine by inquiry of Company officials and/or by reading relevant documentation how the follow-up procedures established by the Company operate and whether an appropriate mechanism exists to follow-up on reports of suspected violations reported to a corporate review board, ombudsman, corporate compliance or ethics office, or similar mechanism to determine what occurred, who was responsible, and recommended corrective and other action.

10. Is there an appropriate mechanism for letting employees know the result of any follow-up into their reported charges?
    a. Determine by inquiry of Company officials and/or by reading relevant documentation whether an appropriate mechanism exists for letting employees know the result of any follow-up into their reported charges.
    b. Determine by inquiry of members of the corporate review board, ombudsman, corporate compliance of ethics office, or similar mechanism whether the results of the Company's follow-up of reported charges have been communicated to employees.

11. Is there an ongoing program of communication to employees, spelling out and re-emphasizing their obligations under the Code of conduct?

and

12. What are the specifics of such a program?
    A. Written communication?
    B. One-on-one communication?
    C. Group meetings?
    D. Visual aids?
    E. Others?

    Determine by inquiry of Company officials and/or by reading relevant documentation the extent of the Company's ongoing program of communication to employees, spelling out and re-emphasizing their obligations under the Code. Note the specific means of communication and compare to the Company's response to Question 12 of the Questionnaire.

13. Does the Company have a procedure for voluntarily reporting violations of federal procurement laws to appropriate governmental agencies?

Determine by inquiry of Company officials and/or by reading relevant documentation how the Company's procedures operate for determining whether violations of federal procurement laws are to be reported to appropriate governmental agencies.

14. Is implementation of the Code's provisions one of the standards by which all levels of supervision are expected to be measured in their performance?

    Determine by inquiry of Company officials and/or by reading relevant documentation, such as position descriptions and personnel policies, whether performance evaluations are to consider supervisors' efforts in the implementation of the Code's provisions as a standard of measurement of their performance.

15. Is there a program to monitor on a continuing basis adherence to the Code of Conduct and compliance with federal procurement laws?

    Determine by inquiry of Company officials and/or by reading relevant documentation how the Company monitors, on a continuing basis, adherence to the Code and compliance with federal procurement laws.

16. Does the Company participate in the industry's "Best Practices Forum"?

    Determine by inquiry of Company officials and/or by reading relevant documentation whether the Company participated in the "Best Practices Forum."

17. Are periodic reports on adherence to the principles made to the Company's Board of Directors or to its audit or other appropriate committee?

    Determine by inquiry of Company officials and/or by reading minutes of the Board of Directors or audit or other appropriate committee meetings or other relevant documentation whether Company officials have reported on adherence to the principles of business ethics and conduct.

18. Are the Company's independent public accountants or a similar independent organization required to comment to the Board of Directors or a committee thereof on the efficacy of the Company's internal procedures for implementing the Company's Code of Conduct?

    Determine by inquiry of Company officials and/or by reading relevant documentation whether the Company's independent accountants or a similar independent organization are required to comment to the Board of Directors or a committee thereof on the efficacy of the Company's internal procedures for implementing the Company's Code.

19. Does the Company have a code of conduct provision or associated policy addressing marketing activities?

    Read the Code or associated policy to determine whether it addresses the following marketing activities:

    a. The gathering of competitive information and the engagement and use of consultants (whether engaged in bid and proposal activity, marketing, research and development, engineering, or other tasks).

b. A description of limitations on information which employees or consultants seek or receive.

20. Does the Company have a code of conduct provision or associated policy requiring that consultants are governed by, and oriented regarding, the Company's code of conduct and relevant associated policies?

    a. Read the Code or associated policy to determine whether consultants engaged in marketing activities are governed by it.

    b. Determine by inquiry of Company officials and/or by reading relevant documentation how the Company orients consultants engaged in marketing activities to the Code and relevant associated policies.

Appendix F

.32 Illustrative Defense Contractor Assertion and Review Report

Defense Industry Questionnaire on Business Ethics and Conduct

Defense Contractor Assertion

Statement of Responses to the Defense Industry Questionnaire on *Business Ethics and Conduct for the period from ________ to ________.*

The affirmative responses in the accompanying *Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from ________ to ________* are based on policies and programs in operation during that period and are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct,* including the Questionnaire.

Attachments:

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from ________ to ________.

Review Report

To the Board of Directors of the XYZ Company

We have reviewed the XYZ Company's *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from ________ to ________*, and the Questionnaire and responses attached thereto. Our review was made in accordance with standards established by the American Institute of Certified Public Accountants. Our review was designed to evaluate whether the XYZ Company had policies and programs in operation during that period that support the affirmative responses to the *Questionnaire.* Our review was not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's *Code of Business Ethics and Conduct* on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon.

A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the affirmative responses in the Questionnaire accompanying the *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from ________ to ________*. Accordingly, we do not express such an opinion.

Based on our review, nothing came to our attention that caused us to believe that the affirmative responses in the Questionnaire accompanying the *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from ________ to ________* referred to above are not appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct,* including the Questionnaire.

[Issue Date: August, 1987; amended: February, 1989; modified: May, 1989.]

2. Responding to Requests for Reports on Matters Relating to Solvency

.33 *Question*—Lenders, as a requisite to the closing of certain secured financings in connection with leveraged buyouts (LBOs), recapitalizations and certain other financial transactions, have sometimes requested written assurance from an accountant regarding the prospective borrower's solvency and related matters.[1] The lender is concerned that such financings not be considered to include a fraudulent conveyance or transfer under the Federal Bankruptcy Code [2] or the relevant state fraudulent conveyance or transfer statute.[3] If the financing is subsequently determined to have included a fraudulent conveyance or transfer, repayment obligations and security interests may be set aside or subordinated to the claims of other creditors.

.34 May an accountant provide assurance concerning "matters relating to solvency" as hereinafter defined?

.35 *Interpretation*—No. For reasons set forth below, an accountant should not provide any form of assurance, through examination, review or agreed-upon procedures engagements, that an entity

- Is not insolvent at the time the debt is incurred or would not be rendered insolvent thereby.
- Does not have unreasonably small capital.
- Has the ability to pay its debts as they mature.

In the context of particular transactions other terms are sometimes used or defined by the parties as equivalents of or substitutes for the terms listed above (e.g., fair salable value of assets exceeds liabilities). These terms, and those matters listed above, are hereinafter referred to as "matters relating to solvency." The prohibition extends to providing assurance concerning all such terms.

.36 The assertions on which an accountant can provide assurance are limited by the attestation standards included in the Statement on Standards for Attestation Engagements, *Attestation Standards* [section 100]. The third

[1] While this interpretation describes requests from secured lenders and summarizes the potential effects of fraudulent conveyance or transfer laws upon such lenders, the interpretation is not limited to requests from lenders. All requests for assurance on matters relating to solvency are governed by this interpretation.

[2] Section 548 of the Federal Bankruptcy Code defines fraudulent transfers and obligations as follows:

"The trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily—

"(1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer occurred or such obligation was incurred, indebted; or

"(2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

"(2)(B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

"(2)(B)(ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or

"(2)(B)(iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured." (Bankruptcy Law Reporter, 3 vols. [Chicago: Commerce Clearing House, 1986], vol. 1, 1339).

[3] State fraudulent conveyance or transfer statutes such as the Uniform Fraudulent Conveyance Act and the Uniform Fraudulent Transfer Act reflect substantially similar provisions. These state laws may be employed absent a declaration of bankruptcy or by a bankruptcy trustee under section 544(1) of the Federal Bankruptcy Code. While the statute of limitations varies from state to state, in some states financing transactions may be vulnerable to challenge for up to six years from closing.

general attestation standard states that the practitioner shall perform the engagement only if he or she has reason to believe that the following conditions exist:

- The assertion is capable of evaluation against reasonable criteria that either have been established by a recognized body or are stated in the presentation of the assertion in a sufficiently clear and comprehensive manner for a knowledgeable reader to be able to understand them.
- The assertion is capable of reasonably consistent estimation or measurement using such criteria.

In addition, the second general attestation standard states that the engagement shall be performed by a practitioner or practitioners having adequate knowledge in the subject matter of the assertion.

.37 The matters relating to solvency mentioned in paragraph .36 above are subject to legal interpretation under, and varying legal definition in, the Federal Bankruptcy Code and various state fraudulent conveyance and transfer statutes. Because these matters are not clearly defined in an accounting sense, and are therefore subject to varying interpretations, they do not provide the accountant with the reasonable criteria required to evaluate the assertion under the third general attestation standard. In addition, lenders are concerned with legal issues on matters relating to solvency and the accountant is generally unable to evaluate or provide assurance on these matters of legal interpretation. Therefore, accountants are precluded from giving any form of assurance on matters relating to solvency or any financial presentation of matters relating to solvency.

.38 The rescinded auditing interpretation titled "Reporting on Solvency," issued in December 1984 (before the attestation standards [section 100], which were effective in September 1986), indicated that accountants' solvency letters should contain definitions for the accountant to use in providing negative assurance. While lenders have defined matters relating to solvency in the context of a particular engagement, experience has shown that use of the lender's definitions by the accountant in a solvency letter could be misunderstood as an assurance by the accountant that a particular financing does not include a fraudulent conveyance or transfer under either federal or state law. Further, those who are not aware that the matters relating to solvency have been specifically defined for the engagement may, as a result of being informed that an accountant has issued a report on matters relating to solvency, infer unwarranted assurance therefrom.

.39 Under existing AICPA standards, the accountant may provide a client with various professional services that may be useful to the client in connection with a financing. These services include

- Audit of historical financial statements.
- Review of historical financial information (a review in accordance with AU section 722, *Interim Financial Information,* of interim financial information or in accordance with Statement on Standards for Accounting and Review Services 1, *Compilation and Review of Financial Statements*).
- Examination or review of pro forma financial information.
- Examination or compilation of prospective financial information (section 200, *Financial Forecasts and Projections).*

.40 In addition, under existing AICPA standards (AU section 622, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement,* section 100, and section 200), the accountant can provide the client and lender with an agreed-upon procedures report. In such an engagement, a client and lender may request that specified procedures be applied to various financial presentations, such as historical financial information, pro forma financial information and prospective financial information, which can be useful to a client or lender in connection with a financing.

.41 The accountant should be aware that certain of the services described in paragraph .39 require that the accountant have an appropriate level of knowledge of the entity's accounting and financial reporting practices and its internal control structure. This has ordinarily been obtained by the accountant auditing historical financial statements of the entity for the most recent annual period or by otherwise obtaining an equivalent knowledge base. When considering acceptance of an engagement relating to a financing, the accountant should consider whether he or she can perform these services without an equivalent knowledge base.

.42 A report on agreed-upon procedures should not provide any assurances on matters relating to solvency or any financial presentation of matters relating to solvency (e.g., fair salable value of assets less liabilities or fair salable value of assets less liabilities, contingent liabilities and other commitments). An accountant's report on the results of applying agreed-upon procedures should

- State that the service has been requested in connection with a financing (no reference should be made to any solvency provisions in the financing agreement).
- State that the sufficiency of the procedures is the sole responsibility of the client and lender and disclaim responsibility for the sufficiency of those procedures.
- State that no representations are provided regarding questions of legal interpretation.
- State that no assurance is provided concerning the borrower's (1) solvency, (2) adequacy of capital or (3) ability to pay its debts.
- State that the procedures should not be taken to supplant any additional inquiries and procedures that the lender should undertake in its consideration of the proposed financing.
- Where applicable, state that an audit of recent historical financial statements has previously been performed and that no audit of any historical financial statements for a subsequent period has been performed. In addition, if other services have been performed pursuant to paragraph .39, they may be referred to.
- Describe the procedures applied (as applicable) to the historical financial information, prospective financial information or pro forma financial information and the accountant's findings.
- Where applicable, state that the procedures were less in scope than (1) an audit in accordance with generally accepted auditing standards; (2) an examination of pro forma financial information, the objective of which is the expression of an opinion on that information; (3) an examination of prospective financial statements in

accordance with standards established by the AICPA, and include an appropriate disclaimer of opinion.

- If procedures have been applied to prospective financial information, state that there will usually be differences between the prospective financial information and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material.
- State that had the accountant performed additional procedures or performed an audit or examination, additional matters might have come to his or her attention that would have been reported.
- State the limitations on the use of the report because it is intended solely for the use of specified parties.
- State that the accountant has no responsibility to update the report.

.43 The report ordinarily is dated at or shortly before the closing date. The financing agreement ordinarily specifies the date, often referred to as the cutoff date, to which the report is to relate (for example, a date three business days before the date of the report). The report should state that the inquiries and other procedures carried out in connection with the report did not cover the period from the cutoff date to the date of the report.

.44 The accountant might consider furnishing the client with a draft of the agreed-upon procedures report. The draft report should deal with all matters expected to be covered in the terms expected to be used in the final report. The draft report should be identified as a draft in order to avoid giving the impression that the procedures described therein have been performed. This practice of furnishing a draft report at an early point permits the accountant to make clear to the client and lender what they may expect the accountant to furnish and gives them an opportunity to change the financing agreement or the agreed-upon procedures if they so desire.

[**.45—.46**] [Superseded, February 1993, by Statement on Auditing Standards No. 72.] (See AU section 634.) [4]

[Issue Date: May, 1988; Amended: February, 1993.]

3. Applicability of Attestation Standards to Litigation Services

.47 *Question*—Paragraph 2 of *Statement on Standards for Attestation Engagements* (SSAE) [section 100.02] provides examples of litigation services provided by practitioners that would not be considered attest engagements as defined by SSAE [section 100]. When does SSAE [section 100] not apply to litigation service engagements?

.48 *Interpretation*—SSAE [section 100] does not apply to litigation services that involve pending or potential formal legal or regulatory proceedings before a "trier of fact" [5] in connection with the resolution of a dispute between two or more parties in any of the following circumstances when the:

a. Practitioner does not issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party.

b. Service comprises being an expert witness.

c. Service comprises being a trier of fact or acting on behalf of one.

[4] [Footnote deleted.]

[5] A "trier of fact" in this section means a court, regulatory body, or government authority; their agents; a grand jury; or an arbitrator or mediator of the dispute.

d. Practitioner's work under the rules of the proceedings is subject to detailed analysis and challenge by each party to the dispute.
e. Practitioner is engaged by an attorney to do work that will be protected by the attorney's work product privilege and such work is not intended to be used for other purposes.

When performing such litigation services, the practitioner should comply with Rule 201, *General Standards,* of the *AICPA Code of Professional Conduct* [ET section 201.01].

.49 *Question*—When does SSAE [section 100] apply to litigation service engagements?

.50 *Interpretation*—SSAE [section 100] apply to litigation service engagements when the practitioner:

a. Expresses a written conclusion about the reliability of a written assertion that is the responsibility of another party and that conclusion and assertion are for the use of others who, under the rules of the proceedings, do not have the opportunity to analyze and challenge such work, or
b. In connection with litigation services, is specifically engaged to perform a service in accordance with SSAE [section 100].

.51 *Question*—Paragraph 2*f* of SSAE [section 100.02*f*] provides the following examples of litigation service engagements that are not considered attest engagements:

> Engagements in which a practitioner is engaged to testify as an expert witness in accounting, auditing, taxation, or other matters, given certain stipulated facts.

What does the term "stipulated facts" as used in paragraph 2*f* of SSAE [section 100.02*f*] mean?

.52 *Interpretation*—The term "stipulated facts" as used in paragraph 2*f* of SSAE [section 100.02*f*] means facts or assumptions that are specified by one or more parties to a dispute to serve as the basis for the development of an expert opinion. It is not used in its typical legal sense of facts agreed to by all parties involved in a dispute.

.53 *Question*—Does Interpretation of Attestation Standards No. 2, *Responding to Requests for Reports on Matters Relating to Solvency* (paragraphs .33—.46) prohibit a practitioner from providing expert testimony, as described in paragraph 2*f* and 2*g* of SSAE [section 100.02*f* and .02*g*], before a "trier of fact" on matters relating to solvency?

.54 *Interpretation*—No. Matters relating to solvency mentioned in paragraph .35 are subject to legal interpretation under, and varying legal definition in, the Federal Bankruptcy Code and various state fraudulent conveyance and transfer statutes. Because these matters are not clearly defined in an accounting sense, and are therefore subject to varying interpretations, they do not provide the practitioner with the reasonable criteria required to evaluate the assertion. Thus, Interpretation of Attestation Standards No. 2, *Responding to Requests for Reports on Matters Relating to Solvency* (paragraphs .33—.46) prohibits a practitioner from providing any form of assurance in reporting upon examination, review or agreed-upon procedures engagements about matters relating to solvency (as defined in paragraph .35).

.55 However, a practitioner who is involved with pending or potential formal legal or regulatory proceedings before a "trier of fact" in connection with the resolution of a dispute between two or more parties may provide an expert opinion or consulting advice about matters relating to solvency. The prohibition in paragraphs .33—.46 does not apply in such engagements because as a part of the legal or regulatory proceedings, each party to the dispute has the opportunity to analyze and challenge the legal definition and interpretation of the matters relating to solvency and the criteria the practitioner uses to evaluate matters related to solvency. Such services are not intended to be used by others who do not have the opportunity to analyze and challenge such definitions and interpretations.

[Issue Date: July, 1990.]

[The next page is 2651.]

AT Section 200

Financial Forecasts and Projections

Source: SSAE No. 1.

Effective for engagements in which the date of completion of the accountant's services on prospective financial statements is September 30, 1986, or later, unless otherwise indicated.

.01 This section sets forth standards and provides guidance to accountants concerning performance and reporting for engagements to examine (paragraphs *.27* through .48), compile (paragraphs .10 through .26), or apply agreed-upon procedures to (paragraphs .49 through .57) prospective financial statements.[1] This section is not applicable to presentations that do not meet the minimum presentation guidelines in Appendix A [paragraph .67] of this section. Such partial presentations are not deemed to be "prospective financial statements."

.02 Whenever an accountant (a) submits, to his client or others, prospective financial statements that he has assembled, or assisted in assembling, that are, or reasonably might be, expected to be used by another (third) party [2] or (b) reports on prospective financial statements that are, or reasonably might be, expected to be used by another (third) party, he should perform one of the engagements described in the preceding paragraph. In deciding whether the prospective financial statements are, or reasonably might be, expected to be used by a third party, the accountant may rely on either the written or oral representation of the responsible party, unless information comes to his attention that contradicts the responsible party's representation. If such third party use of the prospective financial statements is not reasonably expected, the provisions of this section are not applicable unless the accountant has been engaged to examine, compile, or apply agreed-upon procedures to the prospective financial statements.

.03 This section does not provide standards or procedures for engagements involving prospective financial statements used solely in connection with litigation support services, although it provides helpful guidance for many aspects of such engagements and may be referred to as useful guidance in such engagements. *Litigation support services* are engagements involving pending or potential formal legal proceedings before a "trier of fact" in connection with the resolution of a dispute between two or more parties, for example, in circumstances where an accountant acts as an expert witness. This exception is provided because, among other things, the accountant's work in such proceedings is ordinarily subject to detailed analysis and challenge by each party to the dispute. This exception does not apply, however, if the prospective financial statements are for use by third parties who, under the rules of the proceedings, do not have the opportunity for such analysis and challenge. For example, creditors may not have such opportunities when prospective financial statements are submitted to them to secure their agreement to a plan of reorganization.

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[1] Footnote deleted.

[2] However, paragraph .58 permits an exception to this for certain types of budgets.

.04 In reporting on prospective financial statements the accountant may be called on to assist the responsible party in identifying assumptions, gathering information, or assembling the statements.[3] The responsible party is nonetheless responsible for the preparation and presentation of the prospective financial statements because the prospective financial statements are dependent on the actions, plans, and assumptions of the responsible party, and only it can take responsibility for the assumptions. Accordingly, the accountant's engagement should not be characterized in his report or in the document containing his report as including "preparation" of the prospective financial statements. An accountant may be engaged to prepare a financial analysis of a potential project where the engagement includes obtaining the information, making appropriate assumptions, and assembling the presentation. Such an analysis is not, and should not be characterized as, a forecast or projection and would not be appropriate for general use. However, if the responsible party reviewed and adopted the assumptions and presentation, or based its assumptions and presentation on the analysis, the accountant could perform one of the engagements described in this section and issue a report appropriate for general use.

.05 The concept of materiality affects the application of this section to prospective financial statements as materiality affects the application of generally accepted auditing standards to historical financial statements. Materiality is a concept that is judged in light of the expected range of reasonableness of the information; therefore, users should not expect prospective information (information about events that have not yet occurred) to be as precise as historical information.

Definitions

.06 For the purposes of this section the following definitions apply.

Prospective financial statements. Either financial forecasts or financial projections including the summaries of significant assumptions and accounting policies. Although prospective financial statements may cover a period that has partially expired, statements for periods that have completely expired are not considered to be prospective financial statements. Pro forma financial statements [4] and partial presentations [5] are not considered to be prospective financial statements.

Financial forecast. Prospective financial statements that present, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operations, and changes in financial position. A financial forecast is based on the responsible party's assumptions reflecting conditions it expects to exist and the course of action it expects to take. A financial forecast

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[3] Some of these services may not be appropriate if the accountant is to be named as the person reporting on an examination in a filing with the Securities and Exchange Commission (SEC). SEC Release Nos. 33-5992 and 34-15305, "Disclosure of Projections of Future Economic Performance," state that for prospective financial statements filed with the commission, "a person should not be named as an outside reviewer if he actively assisted in the preparation of the projection."

[4] The objective of pro forma financial information is to show what the significant effects on the historical financial information might have been had a consummated or proposed transaction (or event) occurred at an earlier date. Although the transaction in question may be prospective, this section does not apply to such presentations because they are essentially historical financial statements and do not purport to be prospective financial statements. See section 300, *Reporting on Pro Forma Financial Information.* [Footnote revised, October 1991, to reflect the issuance of Statement on Standards for Attestation Engagements, *Reporting on Pro Forma Financial Information.*]

[5] Partial presentations are presentations that do not meet the minimum presentation guidelines in paragraph .67 of this section.

may be expressed in specific monetary amounts as a single point estimate of forecasted results or as a range, where the responsible party selects key assumptions to form a range within which it reasonably expects, to the best of its knowledge and belief, the item or items subject to the assumptions to actually fall. When a forecast contains a range, the range is not selected in a biased or misleading manner, for example, a range in which one end is significantly less expected than the other. Minimum presentation guidelines for prospective financial statements are set forth in Appendix A [paragraph .67] of this section.

Financial projection. Prospective financial statements that present, to the best of the responsible party's knowledge and belief, given one or more hypothetical assumptions, an entity's expected financial position, results of operations, and changes in financial position. A financial projection is sometimes prepared to present one or more hypothetical courses of action for evaluation, as in response to a question such as "What would happen if . . . ?" A financial projection is based on the responsible party's assumptions reflecting conditions it expects would exist and the course of action it expects would be taken, given one or more hypothetical assumptions. A projection, like a forecast, may contain a range. Minimum presentation guidelines for prospective financial statements are set forth in Appendix A [paragraph .67] of this section.

Entity. Any unit, existing or to be formed, for which financial statements could be prepared in accordance with generally accepted accounting principles or another comprehensive basis of accounting.[6] For example, an entity can be an individual, partnership, corporation, trust, estate, association, or governmental unit.

Hypothetical assumption. An assumption used in a financial projection to present a condition or course of action that is not necessarily expected to occur, but is consistent with the purpose of the projection.

Responsible party. The person or persons who are responsible for the assumptions underlying the prospective financial statements. The responsible party usually is management, but it can be persons outside of the entity who do not currently have the authority to direct operations (for example, a party considering acquiring the entity).

Assembly. The manual or computer processing of mathematical or other clerical functions related to the presentation of the prospective financial statements. Assembly does not refer to the mere reproduction and collation of such statements or to the responsible party's use of the accountant's computer processing hardware or software.

Key factors. The significant matters on which an entity's future results are expected to depend. Such factors are basic to the entity's operations and thus encompass matters that affect, among other things, the entity's sales, production, service, and financing activities. Key factors serve as a foundation for prospective financial statements and are the bases for the assumptions.

Uses of Prospective Financial Statements

.07 Prospective financial statements are for either "general use" or "limited use." "General use" of prospective financial statements refers to use of the statements by persons with whom the responsible party is not negotiating directly, for example, in an offering statement of an entity's debt or equity

[6] AU section 623, *Special Reports*, discusses comprehensive bases of accounting other than generally accepted accounting principles.

interests. Because recipients of prospective financial statements distributed for general use are unable to ask the responsible party directly about the presentation, the presentation most useful to them is one that portrays, to the best of the responsible party's knowledge and belief, the expected results. Thus, only a financial forecast is appropriate for general use.

.08 "Limited use" of prospective financial statements refers to use of prospective financial statements by the responsible party alone or by the responsible party and third parties with whom the responsible party is negotiating directly. Examples include use in negotiations for a bank loan, submission to a regulatory agency, and use solely within the entity. Third-party recipients of prospective financial statements intended for limited use can ask questions of the responsible party and negotiate terms directly with it. Any type of prospective financial statements that would be useful in the circumstances would normally be appropriate for limited use. Thus, the presentation may be a financial forecast or a financial projection.

.09 Because a financial projection is not appropriate for general use, an accountant should not consent to the use of his name in conjunction with a financial projection that he believes will be distributed to those who will not be negotiating directly with the responsible party, for example, in an offering statement of an entity's debt or equity interests, unless the projection is used to supplement a financial forecast.

Compilation of Prospective Financial Statements

.10 A compilation of prospective financial statements is a professional service that involves—

a. Assembling, to the extent necessary, the prospective financial statements based on the responsible party's assumptions.

b. Performing the required compilation procedures,[7] including reading the prospective financial statements with their summaries of significant assumptions and accounting policies, and considering whether they appear to be (i) presented in conformity with AICPA presentation guidelines [8] and (ii) not obviously inappropriate.

c. Issuing a compilation report.

.11 A compilation is not intended to provide assurance on the prospective financial statements or the assumptions underlying such statements. Because of the limited nature of the accountant's procedures, a compilation does not provide assurance that the accountant will become aware of significant matters that might be disclosed by more extensive procedures, for example, those performed in an examination of prospective financial statements.

.12 The summary of significant assumptions is essential to the reader's understanding of prospective financial statements. Accordingly, the accountant should not compile prospective financial statements that exclude disclosure of the summary of significant assumptions. Also, the accountant should not compile a financial projection that excludes (a) an identification of the hypothetical assumptions or (b) a description of the limitations on the usefulness of the presentation.

.13 The following standards apply to a compilation of prospective financial statements and to the resulting report:

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[7] See paragraph .68, paragraph 5, for the required procedures.

[8] AICPA presentation guidelines are detailed in the AICPA *Guide for Prospective Financial Statements.*

a. The compilation should be performed by a person or persons having adequate technical training and proficiency to compile prospective financial statements.

b. Due professional care should be exercised in the performance of the compilation and the preparation of the report.

c. The work should be adequately planned, and assistants, if any, should be properly supervised.

d. Applicable compilation procedures should be performed as a basis for reporting on the compiled prospective financial statements. (See paragraph .68 for the procedures to be performed.)

e. The report based on the accountant's compilation of prospective financial statements should conform to the applicable guidance in paragraphs .16 through .26 of this section.

.14 The accountant should consider, after applying the procedures specified in paragraph .68, whether representations or other information he has received appear to be obviously inappropriate, incomplete, or otherwise misleading, and if so, the accountant should attempt to obtain additional or revised information. If he does not receive such information, the accountant should ordinarily withdraw from the compilation engagement.[9] (Note that the omission of disclosures, other than those relating to significant assumptions, would not require the accountant to withdraw, see paragraph .24.)

Working Papers

.15 Although it is not possible to specify the form or content of the working papers that an accountant should prepare in connection with a compilation of prospective financial statements because of the different circumstances of individual engagements, the accountant's working papers ordinarily should indicate that—

a. The work was adequately planned and supervised.

b. The required compilation procedures were performed as a basis for the compilation report.

Reports on Compiled Prospective Financial Statements

.16 The accountant's standard report on a compilation of prospective financial statements should include—

a. An identification of the prospective financial statements presented by the responsible party.

b. A statement that the accountant has compiled the prospective financial statements in accordance with standards established by the American Institute of Certified Public Accountants.

c. A statement that a compilation is limited in scope and does not enable the accountant to express an opinion or any other form of assurance on the prospective financial statements or the assumptions.

d. A caveat that the prospective results may not be achieved.

e. A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

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[9] The accountant need not withdraw from the engagement if the effect of such information on the prospective financial statement does not appear to be material.

.17 The following is the form of the accountant's standard report on the compilation of a forecast that does not contain a range.[10]

> We have compiled the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending, in accordance with standards established by the American Institute of Certified Public Accountants.[11]
>
> A compilation is limited to presenting in the form of a forecast information that is the representation of management [12] and does not include evaluation of the support for the assumptions underlying the forecast. We have not examined the forecast and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.18 When the presentation is a projection, the accountant's report should include a separate paragraph that describes the limitations on the usefulness of the presentation. The following is the form of the accountant's standard report on a compilation of a projection that does not contain a range.

> We have compiled the accompanying projected balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending, in accordance with standards established by the American Institute of Certified Public Accountants.[13]
>
> The accompanying projection and this report were prepared for [*state special purpose, for example, "the DEF National Bank for the purpose of negotiating a loan to expand XYZ Company's plant,"*] and should not be used for any other purpose.
>
> A compilation is limited to presenting in the form of a projection information that is the representation of management and does not include evaluation of the support for the assumptions underlying the projection. We have not examined the projection and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, even if [*describe hypothetical assumption, for example, "the loan is granted and the plant is expanded,"*] there will usually be differences between the projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.19 When the prospective financial statements contain a range, the accountant's standard report should also include a separate paragraph that states that the responsible party has elected to portray the expected results of one or more assumptions as a range. The following is an example of the

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[10] The forms of reports provided in this section are appropriate whether the presentation is based on generally accepted accounting principles or on another comprehensive basis of accounting.

[11] When the presentation is summarized as discussed in paragraph .67 of this section, this sentence might read "We have compiled the accompanying summarized forecast of XYZ Company as of December 31, 19XX, and for the year then ending, in accordance with standards established by the American Institute of Certified Public Accountants."

[12] When the responsible party is other than management, the references to management in the standard reports provided in this section should be changed to refer to the party who assumes responsibility for the assumptions.

[13] When the presentation is summarized as discussed in paragraph .67 of this section, this sentence might read "We have compiled the accompanying summarized projection of XYZ Company as of December 31, 19XX, and for the year then ending, in accordance with standards established by the American Institute of Certified Public Accountants."

separate paragraph to be added to the accountant's report when he compiles prospective financial statements, in this case a forecast, that contain a range.

> As described in the summary of significant assumptions, management of XYZ Company has elected to portray forecasted [*describe financial statement element or elements for which the expected results of one or more assumptions fall within a range, and identify the assumptions expected to fall within a range, for example, "revenue at the amounts of $X,XXX and $Y,YYY, which is predicated upon occupancy rates of XX percent and YY percent of available apartments,"*] rather than as a single point estimate. Accordingly, the accompanying forecast presents forecasted financial position, results of operations, and changes in financial position [*describe one or more assumptions expected to fall within a range, for example, "at such occupancy rates."*] However, there is no assurance that the actual results will fall within the range of [*describe one or more assumptions expected to fall within a range, for example, "occupancy rates"*] presented.

.20 The date of completion of the accountant's compilation procedures should be used as the date of the report.

.21 An accountant may compile prospective financial statements for an entity with respect to which he is not independent.[14] In such circumstances, the accountant should specifically disclose his lack of independence; however, the reason for the lack of independence should not be described. When the accountant is not independent, he may give the standard compilation report but should include the following sentence after the last paragraph.

> We are not independent with respect to XYZ Company.

.22 Prospective financial statements may be included in a document that also contains historical financial statements and the accountant's report thereon.[15] In addition, the historical financial statements that appear in the document may be summarized and presented with the prospective financial statements for comparative purposes.[16] An example of the reference to the accountant's report on the historical financial statements when he audited, reviewed, or compiled those statements is presented below.

(concluding sentence of last paragraph)

> The historical financial statements for the year ended December 31, 19XX, (from which the historical data are derived) and our report thereon are set forth on pages xx-xx of this document.

.23 In some circumstances, an accountant may wish to expand his report to emphasize a matter regarding the prospective financial statements. Such information may be presented in a separate paragraph of the accountant's report. However, the accountant should exercise care that emphasizing such a matter does not give the impression that he is expressing assurance or expanding the degree of responsibility he is taking with respect to such information.[17] For example, the accountant should not include statements in his

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[14] In making a judgment about whether he is independent, the accountant should be guided by the AICPA Code of Professional Conduct. Also, see the auditing interpretation "Applicability of Guidance on Reporting When Not Independent" (AU section 9504.19—.22).

[15] The accountant's responsibility with respect to those historical financial statements upon which he is not engaged to perform a professional service is described in AU section 504, *Association With Financial Statements,* in the case of public entities, and Statement on Standards for Accounting and Review Services (SSARS) No. 1, *Compilation and Review of Financial Statements,* paragraphs 5 through 7 [AR section 100.05—.07], in the case of nonpublic entities.

[16] AU section 552, *Reporting on Condensed Financial Statements and Selected Financial Data,* discusses the accountant's report where summarized financial statements are derived from audited statements that are not included in the same document.

[17] However, the accountant may provide assurance on tax matters in order to comply with the requirements of regulations governing practice before the Internal Revenue Service contained in 31 C.F.R. pt. 10 (Treasury Department Circular No. 230.)

compilation report about the mathematical accuracy of the statements or their conformity with presentation guidelines.

Modifications of the Standard Compilation Report

.24 An entity may request an accountant to compile prospective financial statements that contain presentation deficiencies or omit disclosures other than those relating to significant assumptions. The accountant may compile such prospective financial statements provided the deficiency or omission is clearly indicated in his report and is not, to his knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such statements.

.25 Notwithstanding the above, if the compiled prospective financial statements are presented on a comprehensive basis of accounting other than generally accepted accounting principles and do not include disclosure of the basis of accounting used, the basis should be disclosed in the accountant's report.

.26 The following is an example of a paragraph that should be added to a report on compiled prospective financial statements, in this case a financial forecast, in which the summary of significant accounting policies has been omitted.

> Management has elected to omit the summary of significant accounting policies required by the guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants. If the omitted disclosures were included in the forecast, they might influence the user's conclusions about the Company's financial position, results of operations, and changes in financial position for the forecast period. Accordingly, this forecast is not designed for those who are not informed about such matters.

Examination of Prospective Financial Statements

.27 An examination of prospective financial statements is a professional service that involves—

a. Evaluating the preparation of the prospective financial statements.

b. Evaluating the support underlying the assumptions.

c. Evaluating the presentation of the prospective financial statements for conformity with AICPA presentation guidelines.[18]

d. Issuing an examination report.

.28 As a result of his examination, the accountant has a basis for reporting on whether, in his opinion—

a. The prospective financial statements are presented in conformity with AICPA guidelines.

b. The assumptions provide a reasonable basis for the responsible party's forecast, or whether the assumptions provide a reasonable basis for the responsible party's projection given the hypothetical assumptions.

.29 The accountant should be independent; have adequate technical training and proficiency to examine prospective financial statements; adequately plan the engagement and supervise the work of assistants, if any; and obtain sufficient evidence to provide a reasonable basis for his examination report. (See paragraph .69 of this section for standards concerning such technical training and proficiency, planning the examination engagement, and

[18] AICPA presentation guidelines are detailed in the AICPA *Guide for Prospective Financial Statements.*

the types of procedures an accountant should perform to obtain sufficient evidence for his examination report.)

Working Papers

.30 The accountant's working papers in connection with his examination of prospective financial statements should be appropriate to the circumstances and the accountant's needs on the engagement to which they apply. Although the quantity, type, and content of working papers vary with the circumstances, they ordinarily should indicate that—

a. The work was adequately planned and supervised.

b. The process by which the entity develops its prospective financial statements was considered in determining the scope of the examination.

c. Sufficient evidence was obtained to provide a reasonable basis for the accountant's report.

Reports on Examined Prospective Financial Statements

.31 The accountant's standard report on an examination of prospective financial statements should include—

a. An identification of the prospective financial statements presented.

b. A statement that the examination of the prospective financial statements was made in accordance with AICPA standards and a brief description of the nature of such an examination.

c. The accountant's opinion that the prospective financial statements are presented in conformity with AICPA presentation guidelines[19] and that the underlying assumptions provide a reasonable basis for the forecast or a reasonable basis for the projection given the hypothetical assumptions.

d. A caveat that the prospective results may not be achieved.

e. A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

.32 The following is the form of the accountant's standard report on an examination of a forecast that does not contain a range.

> We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending.[20] Our examination was made in accordance with standards for an examination of a forecast established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast.
>
> In our opinion, the accompanying forecast is presented in conformity with guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's forecast. However, there will usually be

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[19] The accountant's report need not comment on the consistency of the application of accounting principles as long as the presentation of any change in accounting principles is in conformity with AICPA presentation guidelines as detailed in the AICPA *Guide for Prospective Financial Statements.*

[20] When the presentation is summarized as discussed in Appendix A [paragraph .67] of this section, this sentence might read "We have examined the accompanying summarized forecast of XYZ Company as of December 31, 19XX, and for the year then ending."

differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.33 When an accountant examines a projection, his opinion regarding the assumptions should be conditioned on the hypothetical assumptions; that is, he should express an opinion on whether the assumptions provide a reasonable basis for the projection given the hypothetical assumptions. Also, his report should include a separate paragraph that describes the limitations on the usefulness of the presentation. The following is the form of the accountant's standard report on an examination of a projection that does not contain a range.

We have examined the accompanying projected balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending.[21] Our examination was made in accordance with standards for an examination of a projection established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the projection.

The accompanying projection and this report were prepared for [*state special purpose, for example, "the DEF National Bank for the purpose of negotiating a loan to expand XYZ Company's plant,"*] and should not be used for any other purpose.

In our opinion, the accompanying projection is presented in conformity with guidelines for presentation of a projection established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's projection [*describe the hypothetical assumption, for example, "assuming the granting of the requested loan for the purpose of expanding XYZ Company's plant as described in the summary of significant assumptions."*] However, even if [*describe hypothetical assumption, for example, "the loan is granted and the plant is expanded,"*] there will usually be differences between the projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.34 When the prospective financial statements contain a range, the accountant's standard report should also include a separate paragraph that states that the responsible party has elected to portray the expected results of one or more assumptions as a range. The following is an example of the separate paragraph to be added to the accountant's report when he examines prospective financial statements, in this case a forecast, that contain a range.

As described in the summary of significant assumptions, management of XYZ Company has elected to portray forecasted [*describe financial statement element or elements for which the expected results of one or more assumptions fall within a range, and identify assumptions expected to fall within a range, for example, "revenue at the amounts of $X,XXX and $Y,YYY, which is predicated upon occupancy rates of XX percent and YY percent of available apartments,"*] rather than as a single point estimate. Accordingly, the accompanying forecast presents forecasted financial position, results of operations and changes in financial position [*describe one or more assumptions expected to fall within a range, for example, "at such occupancy rates."*] However, there is no assurance that the actual results

[21] When the presentation is summarized as discussed in paragraph .67 of this section, this sentence might read "We have examined the accompanying summarized projection of XYZ Company as of December 31, 19XX, and for the year then ending."

will fall within the range of [*describe one or more assumptions expected to fall within a range, for example, "occupancy rates"*] presented.

.35 The date of completion of the accountant's examination procedures should be used as the date of the report.

Modifications to the Accountant's Opinion

.36 The following circumstances result in the following types of modified accountant's report involving the accountant's opinion:

a. If, in the accountant's opinion, the prospective financial statements depart from AICPA presentation guidelines, he should issue a qualified opinion (see paragraph .37) or an adverse opinion (see paragraph .39).[22] However, if the presentation departs from the presentation guidelines because it fails to disclose assumptions that appear to be significant the accountant should issue an adverse opinion (see paragraphs .39 and .40).

b. If the accountant believes that one or more significant assumptions do not provide a reasonable basis for the forecast, or a reasonable basis for the projection given the hypothetical assumptions, he should issue an adverse opinion (see paragraph .39).

c. If the accountant's examination is affected by conditions that preclude application of one or more procedures he considers necessary in the circumstances, he should disclaim an opinion and describe the scope limitation in his report (see paragraph .41).

.37 *Qualified Opinion.* In a qualified opinion, the accountant should state, in a separate paragraph, all of his substantive reasons for modifying his opinion and describe the departure from AICPA presentation guidelines. His opinion should include the words "except" or "exception" as the qualifying language and should refer to the separate explanatory paragraph. The following is an example of an examination report on a forecast that is at variance with AICPA guidelines for presentation of a financial forecast.

> We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending. Our examination was made in accordance with standards for an examination of a forecast established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast.
>
> The forecast does not disclose reasons for the significant variation in the relationship between income tax expense and pretax accounting income as required by generally accepted accounting principles.
>
> In our opinion, except for the omission of the disclosure of the reasons for the significant variation in the relationship between income tax expense and pretax accounting income as discussed in the preceding paragraph, the accompanying forecast is presented in conformity with guidelines for a presentation of a forecast established by the American Institute of Certified Public Accountants and the underlying assumptions provide a reasonable basis for management's forecast. However, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material.

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[22] However, the accountant may issue the standard examination report on a financial forecast filed with the SEC that meets the presentation requirements of article XI of Regulation S-X.

We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.38 Because of the nature, sensitivity, and interrelationship of prospective information, a reader would find an accountant's report qualified for a measurement departure,[23] the reasonableness of the underlying assumptions, or a scope limitation difficult to interpret. Accordingly, the accountant should not express his opinion about these items with language such as "except for . . ." or "subject to the effects of . . . ." Rather, when a measurement departure, an unreasonable assumption, or a limitation on the scope of the accountant's examination has led him to conclude that he cannot issue an unqualified opinion, he should issue the appropriate type of modified opinion described in paragraphs .39 through .42.

.39 *Adverse Opinion.* In an adverse opinion the accountant should state, in a separate paragraph, all of his substantive reasons for his adverse opinion. His opinion should state that the presentation is not in conformity with presentation guidelines and should refer to the explanatory paragraph. When applicable, his opinion paragraph should also state that, in the accountant's opinion, the assumptions do not provide a reasonable basis for the prospective financial statements. An example of an adverse opinion on an examination of prospective financial statements is set forth below. In this case, a financial forecast was examined and the accountant's opinion was that a significant assumption was unreasonable. The example should be revised as appropriate for a different type of presentation or if the adverse opinion is issued because the statements do not conform to the presentation guidelines.

> We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending. Our examination was made in accordance with standards for an examination of a financial forecast established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast.
>
> As discussed under the caption "Sales" in the summary of significant forecast assumptions, the forecasted sales include, among other things, revenue from the Company's federal defense contracts continuing at the current level. The Company's present federal defense contracts will expire in March 19XX. No new contracts have been signed and no negotiations are under way for new federal defense contracts. Furthermore, the federal government has entered into contracts with another company to supply the items being manufactured under the Company's present contracts.
>
> In our opinion, the accompanying forecast is not presented in conformity with guidelines for presentation of a financial forecast established by the American Institute of Certified Public Accountants because management's assumptions, as discussed in the preceding paragraph, do not provide a reasonable basis for management's forecast. We have no responsibility to update this report for events or circumstances occurring after the date of this report.

.40 If the presentation, including the summary of significant assumptions, fails to disclose assumptions that, at the time, appear to be significant, the accountant should describe the assumptions in his report and issue an adverse opinion. The accountant should not examine a presentation that omits all disclosures of assumptions. Also, the accountant should not examine a financial projection that omits (a) an identification of the hypothetical

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[23] An example of a measurement departure is the failure to capitalize a capital lease in a forecast where the historical financial statements for the prospective period are expected to be presented in conformity with generally accepted accounting principles.

assumptions or (b) a description of the limitations on the usefulness of the presentation.

.41 *Disclaimer of Opinion.* In a disclaimer of opinion the accountant's report should indicate, in a separate paragraph, the respects in which the examination did not comply with standards for an examination. The accountant should state that the scope of the examination was not sufficient to enable him to express an opinion with respect to the presentation or the underlying assumptions, and his disclaimer of opinion should include a direct reference to the explanatory paragraph. The following is an example of a report on an examination of prospective financial statements, in this case a financial forecast, for which a significant assumption could not be evaluated.

> We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending. Except as explained in the following paragraph, our examination was made in accordance with standards for an examination of a financial forecast established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast.
>
> As discussed under the caption "Income From Investee" in the summary of significant forecast assumptions, the forecast includes income from an equity investee constituting 23 percent of forecasted net income, which is management's estimate of the Company's share of the investee's income to be accrued for 19XX. The investee has not prepared a forecast for the year ending December 31, 19XX, and we were therefore unable to obtain suitable support for this assumption.
>
> Because, as described in the preceding paragraph, we are unable to evaluate management's assumption regarding income from an equity investee and other assumptions that depend thereon, we express no opinion with respect to the presentation of or the assumptions underlying the accompanying forecast. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.42 When there is a scope limitation and the accountant also believes there are material departures from the presentation guidelines, those departures should be described in the accountant's report.

Other Modifications to the Standard Examination Report

.43 The circumstances described below, although not necessarily resulting in modifications to the accountant's opinion, would result in the following types of modifications to the standard examination report.

.44 *Emphasis of a Matter.* In some circumstances, the accountant may wish to emphasize a matter regarding the prospective financial statements but nevertheless intends to issue an unqualified opinion. The accountant may present other information and comments he wishes to include, such as explanatory comments or other informative material, in a separate paragraph of his report.

.45 *Evaluation Based in Part on a Report of Another Accountant.* When more than one accountant is involved in the examination, the guidance provided for that situation in connection with examinations of historical financial statements is generally applicable. When the principal accountant decides to refer to the report of another accountant as a basis, in part, for his own opinion, he should disclose that fact in stating the scope of the examination and should refer to the report of the other accountant in expressing his opinion. Such a reference indicates the division of responsibility for the performance of the examination.

.46 *Comparative Historical Financial Information.* Prospective financial statements may be included in a document that also contains historical financial statements and an accountant's report thereon.[24] In addition, the historical financial statements that appear in the document may be summarized and presented with the prospective financial statements for comparative purposes.[25] An example of the reference to the accountant's report on the historical financial statements when he examined, reviewed, or compiled those statements is presented in paragraph .22.

.47 *Reporting When the Examination Is Part of a Larger Engagement.* When the accountant's examination of prospective financial statements is part of a larger engagement, for example, a financial feasibility study or business acquisition study, it is appropriate to expand the report on the examination of the prospective financial statements to describe the entire engagement.

.48 The following is a report that might be issued when an accountant chooses to expand his report on a financial feasibility study.[26]

a. The Board of Directors
Example Hospital
Example, Texas

b. We have prepared a financial feasibility study of Example Hospital's plans to expand and renovate its facilities. The study was undertaken to evaluate the ability of Example Hospital (the Hospital) to meet the Hospital's operating expenses, working capital needs, and other financial requirements, including the debt service requirements associated with the proposed $25,000,000 [*legal title of bonds*] issue, at an assumed average annual interest rate of 10.0 percent during the five years ending December 31, 19X6.

c. The proposed capital improvements program (the Program) consists of a new two-level addition, which is to provide fifty additional medical-surgical beds, increasing the complement to 275 beds. In addition, various administrative and support service areas in the present facilities are to be remodeled. The Hospital administration anticipates that construction is to begin June 30, 19X2, and to be completed by December 31, 19X3.

d. The estimated total cost of the Program is approximately $30,000,000. It is assumed that the $25,000,000 of revenue bonds that the Example Hospital Finance Authority proposes to issue

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[24] The accountant's responsibility with respect to those historical financial statements upon which he is not engaged to perform a professional service is described in AU section 504, *Association With Financial Statements,* in the case of public entities, and SSARS No. 1, *Compilation and Review of Financial Statements,* paragraphs 5 through 7 [AR section 100.05—.07], in the case of nonpublic entities.

[25] AU section 552, *Reporting on Condensed Financial Statements and Selected Financial Data,* discusses the accountant's report for summarized financial statements derived from audited financial statements that are not included in the same document.

[26] Although the entity referred to in the report is a hospital, the form of report is also applicable to other entities such as hotels or stadiums. Also, although the illustrated report format and language should not be departed from in any significant way, the language used should be tailored to fit the circumstances that are unique to a particular engagement (for example, the description of the proposed capital improvement program, paragraph c; the proposed financing of the program, paragraphs b and d; the specific procedures applied by the accountant, paragraph e; and any explanatory comments included in emphasis-of-a-matter paragraphs, paragraph i, which deals with general matter; and paragraph j, which deals with specific matters).

would be the primary source of funds for the Program. The responsibility for payment of debt service on the bonds is solely that of the Hospital. Other necessary funds to finance the Program are assumed to be provided from the Hospital's funds, from a local fund drive, and from interest earned on funds held by the bond trustee during the construction period.

e. Our procedures included analysis of—

- Program history, objectives, timing and financing.
- The future demand for the Hospital's services, including consideration of—

  Economic and demographic characteristics of the Hospital's defined service area.

  Locations, capacities, and competitive information pertaining to other existing and planned area hospitals.

  Physician support for the Hospital and its programs.

  Historical utilization levels.
- Planning agency applications and approvals.
- Construction and equipment costs, debt service requirements, and estimated financing costs.
- Staffing patterns and other operating considerations.
- Third-party reimbursement policy and history.
- Revenue/expense/volume relationships.

f. We also participated in gathering other information, assisted management in identifying and formulating its assumptions, and assembled the accompanying financial forecast based on those assumptions.

g. The accompanying financial forecast for the annual periods ending December 31, 19X2, through 19X6, is based on assumptions that were provided by or reviewed with and approved by management. The financial forecast includes—

- Balance sheets.
- Statements of revenues and expenses.
- Statements of changes in financial position.
- Statements of changes in fund balance.

h. We have examined the financial forecast. Our examination was made in accordance with standards for an examination of a financial forecast established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast.

i. Legislation and regulations at all levels of government have affected and may continue to affect revenues and expenses of hospitals. The financial forecast is based on legislation and regulations currently in effect. If future legislation or regulations related to hospital operations are enacted, such legislation or regulations could have a material effect on future operations.

j. The interest rate, principal payments, Program costs, and other financing assumptions are described in the section entitled "Summary of Significant Forecast Assumptions and Rationale." If actual interest rates, principal payments, and funding requirements are different from those assumed, the amount of the bond issue and debt service requirements would need to be adjusted accordingly from those indicated in the forecast. If such interest rates, principal payments, and funding requirements are lower than those assumed, such adjustments would not adversely affect the forecast.

k. Our conclusions are presented below.

- In our opinion, the accompanying financial forecast is presented in conformity with guidelines for presentation of a financial forecast established by the American Institute of Certified Public Accountants.
- In our opinion, the underlying assumptions provide a reasonable basis for management's forecast. However, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material.
- The accompanying financial forecast indicates that sufficient funds could be generated to meet the Hospital's operating expenses, working capital needs, and other financial requirements, including the debt service requirements associated with the proposed $25,000,000 bond issue, during the forecast periods. However, the achievement of any financial forecast is dependent on future events, the occurrence of which cannot be assured.

l. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Applying Agreed-Upon Procedures to Prospective Financial Statements

.49 An accountant may accept an engagement to apply agreed-upon procedures to prospective financial statements provided that (a) the specified users involved have participated in establishing the nature and scope of the engagement and take responsibility for the adequacy of the procedures to be performed, (b) distribution of the report is to be restricted to the specified users involved, and (c) the prospective financial statements include a summary of significant assumptions.[27]

.50 The accountant who accepts an engagement to apply agreed-upon procedures to prospective financial statements should be independent; have adequate technical training and proficiency to apply agreed-upon procedures to prospective financial statements; adequately plan the engagement and supervise the work of assistants, if any; and obtain sufficient evidence to provide a reasonable basis for his report on the results of applying the agreed-upon procedures.

.51 The accountant's procedures generally may be as limited or extensive as the specified users desire as long as the specified users take responsibility for their adequacy. However, mere reading of prospective financial statements

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[27] Accountants should follow the guidance in AU section 634, *Letters for Underwriters and Certain Other Requesting Parties*, when requested to perform agreed-upon procedures on a forecast and report thereon in a letter for an underwriter (see AU section 634.43). [Footnote added, February 1993, by the issuance of Statement on Auditing Standards No. 72.]

does not constitute a procedure sufficient to permit an accountant to report on the results of applying agreed-upon procedures to such statements.

.52 To satisfy the requirement that the specified users involved participate in establishing the nature and scope of the engagement and take responsibility for the adequacy of the procedures to be performed, the accountant ordinarily should meet with the specified users involved to discuss the procedures to be followed. This discussion may include describing, to the specified users, procedures that are frequently followed in similar types of engagements. Sometimes the accountant may not be able to discuss the procedures directly with all of the specified users who will receive the report. In such circumstances, the accountant may satisfy the requirement that the specified users involved take responsibility for the adequacy of the procedures by applying any one of the following or similar procedures:

a. Discussing the procedures to be applied with legal counsel or other appropriate designated representatives of the users involved, such as, a trustee, a receiver, or a creditors' committee.

b. Reviewing relevant correspondence from the specified users.

c. Comparing the procedures to be applied to written requirements of a supervisory agency.

d. Distributing a draft of the report or a copy of the client's engagement letter to the specified users involved with a request for their comments before the report is issued.

Working Papers

.53 Although it is not possible to specify the form or content of the working papers that an accountant should prepare in connection with an engagement to apply agreed-upon procedures to prospective financial statements because of the different circumstances of individual engagements, the accountant's working papers ordinarily should indicate that—

a. The work was adequately planned and supervised.

b. The agreed-upon procedures were performed as a basis for the report.

Reports on the Results of Applying Agreed-Upon Procedures

.54 The accountant's report on the results of applying agreed-upon procedures should—

a. Indicate the prospective financial statements covered by the accountant's report.

b. Indicate that the report is limited in use, intended solely for the specified users, and should not be used by others.

c. Enumerate the procedures performed and refer to conformity with the arrangements made with the specified users.

d. If the agreed-upon procedures are less than those performed in an examination, state that the work performed was less in scope than an examination of prospective financial statements in accordance with AICPA standards and disclaim an opinion on whether the presentation of the prospective financial statements is in conformity with AICPA presentation guidelines and on whether the underlying assumptions provide a reasonable basis for the forecast, or a reasonable basis for the projection given the hypothetical assumptions.

e. State the accountant's findings.

f. Include a caveat that the prospective results may not be achieved.

g. State that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

.55 Also, the accountant may wish to state in his report that he makes no representation about the sufficiency of the procedures for the specified users' purposes.

.56 When the accountant reports on the results of applying agreed-upon procedures, he should not express any form of negative assurance on the prospective financial statements taken as a whole.

.57 The following two exhibits illustrate reports that might be issued when the engagement is limited to applying agreed-upon procedures to the prospective financial statements.

Exhibit 1

Board of Directors—XYZ Corporation

Board of Directors—ABC Company

At your request, we have performed certain agreed-upon procedures, as enumerated below, with respect to the forecasted balance sheet, statements of income, retained earnings and changes in financial position of DEF Company, a subsidiary of ABC Company, as of December 31, 19XX, and for the year then ending. These procedures, which were specified by the Boards of Directors of XYZ Corporation and ABC Company, were performed solely to assist you in connection with the proposed sale of DEF Company to XYZ Corporation. It is understood that this report is solely for your information and should not be used by those who did not participate in determining the procedures.

a. With respect to forecasted rental income, we compared the assumptions about expected demand for rental of the housing units to demand for similar housing units at similar rental prices in the city area in which DEF Company's housing units are located.

b. We tested the forecast for mathematical accuracy.

Because the procedures described above do not constitute an examination of prospective financial statements in accordance with standards established by the American Institute of Certified Public Accountants, we do not express an opinion on whether the prospective financial statements are presented in conformity with AICPA presentation guidelines or on whether the underlying assumptions provide a reasonable basis for the presentation.

In connection with the procedures referred to above, no matters came to our attention that caused us to believe that rental income should be adjusted or that the forecast is mathematically inaccurate. Had we performed additional procedures or had we made an examination of the forecast in accordance with standards established by the American Institute of Certified Public Accountants, matters might have come to our attention that would have been reported to you. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Exhibit 2

ABC Trustee

XYZ Company

At your request, we performed the agreed-upon procedures enumerated below with respect to the forecasted balance sheet, statements of income, retained earnings and changes in financial position of XYZ Company as of December 31, 19XX, and for the year then ending. These procedures, which were specified by ABC Trustee and XYZ Company, were performed solely to assist you, and this report is solely for your information and should not be used by those who did not participate in determining the procedures.

a. We assisted the management of XYZ Company in assembling the prospective financial statements.

b. We read the prospective financial statements for compliance in regard to format with the presentation guidelines established by the American Institute of Certified Public Accountants for presentation of a forecast.

c. We tested the forecast for mathematical accuracy.

Because the procedures described above do not constitute an examination of prospective financial statements in accordance with standards established by the American Institute of Certified Public Accountants, we do not express an opinion on whether the prospective financial statements are presented in conformity with AICPA presentation guidelines or on whether the underlying assumptions provide a reasonable basis for the presentation.

In connection with the procedures referred to above, no matters came to our attention that caused us to believe that the format of the forecast should be modified or that the forecast is mathematically inaccurate. Had we performed additional procedures or had we made an examination of the forecast in accordance with standards established by the American Institute of Certified Public Accountants, matters might have come to our attention that would have been reported to you. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Other Information

.58 When an accountant's compilation, review, or examination report on historical financial statements is included in an accountant-submitted document containing prospective financial statements, the accountant should either examine, compile, or apply agreed-upon procedures to the prospective financial statements and report accordingly, unless (a) the prospective financial statements are labeled as a "budget," (b) the budget does not extend beyond the end of the current fiscal year, and (c) the budget is presented with interim historical financial statements for the current year. In such circumstances, the accountant need not examine, compile, or apply agreed-upon procedures to the budget; however, he should report on it and (a) indicate that he did not examine or compile the budget and (b) disclaim an opinion or any other form of assurance on the budget. In addition, the budgeted information may omit the summaries of significant assumptions and accounting policies required by the guidelines for presentation of prospective financial statements established by the American Institute of Certified Public Accountants, provided such omission is not, to the accountant's knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such budgeted information, and is disclosed in the accountant's report. The following is the form of the standard paragraphs to be added to the accountant's report in this circumstance when the summaries of significant assumptions and accounting policies have been omitted.

> The accompanying budgeted balance sheet, statements of income, retained earnings, and changes in financial position of XYZ Company as of December 31, 19XX, and for the six months then ending, have not been compiled or examined by us, and, accordingly, we do not express an opinion or any other form of assurance on them.
>
> Management has elected to omit the summaries of significant assumptions and accounting policies required under established guidelines for presentation of prospective financial statements. If the omitted summaries were included in the budgeted information, they might influence the user's conclusions about the company's budgeted information. Accordingly, this budgeted information is not designed for those who are not informed about such matters.

.59 When the accountant's compilation, review, or examination report on historical financial statements is included in a client-prepared document containing prospective financial statements, the accountant should not consent to the use of his name in the document unless (a) he has examined, compiled, or applied agreed-upon procedures to the prospective financial statements and his report accompanies them, (b) the prospective financial statements are accompanied by an indication by the responsible party or the accountant that the accountant has not performed such a service on the prospective financial statements and that the accountant assumes no responsibility for them, or (c) another accountant has examined, compiled, or applied agreed-upon procedures to the prospective financial statements and his report is included in the document. In addition, if the accountant has examined the historical financial statements and they accompany prospective financial statements that he did not examine, compile, or apply agreed-upon procedures to in certain [28] client-prepared documents, he should refer to AU section 550, *Other Information in Documents Containing Audited Financial Statements*.

.60 The accountant whose report on prospective financial statements is included in a client-prepared document containing historical financial statements should not consent to the use of his name in the document unless (a) he has compiled, reviewed, or examined the historical financial statements and his report accompanies them, (b) the historical financial statements are accompanied by an indication by the responsible party or the accountant that the accountant has not performed such a service on the historical financial statements and that the accountant assumes no responsibility for them, or (c) another accountant has compiled, reviewed, or examined the historical financial statements and his report is included in the document.

.61 An entity may publish various documents that contain information other than historical financial statements in addition to the compiled or examined prospective financial statements and the accountant's report thereon. The accountant's responsibility with respect to information in such a document does not extend beyond the financial information identified in the report, and he has no obligation to perform any procedures to corroborate other information contained in the document. However, the accountant should

[28] AU section 550 applies only to such prospective financial statements contained in (a) annual reports to holders of securities or beneficial interests, annual reports of organizations for charitable or philanthropic purposes distributed to the public, and annual reports filed with regulatory authorities under the Securities Exchange Act of 1934 or (b) other documents to which the auditor, at the client's request, devotes attention. AU section 550 does not apply when the historical financial statements and report appear in a registration statement filed under the Securities Act of 1933 (in which case, see AU section 711, *Filings Under Federal Securities Statutes*). [Footnote renumbered by Statement on Auditing Standards No. 72, February 1993.]

read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with the information, or manner of its presentation, appearing in the prospective financial statements.

.62 If the accountant examines prospective financial statements included in a document containing inconsistent information, he might not be able to conclude that there is adequate support for each significant assumption. The accountant should consider whether the prospective financial statements, his report, or both require revision. Depending on the conclusion he reaches, the accountant should consider other actions that may be appropriate, such as issuing an adverse opinion, disclaiming an opinion because of a scope limitation, withholding the use of his report in the document, or withdrawing from the engagement.

.63 If the accountant compiles the prospective financial statements included in the document containing inconsistent information, he should attempt to obtain additional or revised information. If he does not receive such information, the accountant should withhold the use of his report or withdraw from the compilation engagement.

.64 If, while reading the other information appearing in the document containing the examined or compiled prospective financial statements, as described in the preceding paragraphs, the accountant becomes aware of information that he believes is a material misstatement of fact that is not an inconsistent statement, he should discuss the matter with the responsible party. In connection with this discussion, the accountant should consider that he may not have the expertise to assess the validity of the statement made, that there may be no standards by which to assess its presentation, and that there may be valid differences of judgment or opinion. If the accountant concludes that he has a valid basis for concern, he should propose that the responsible party consult with some other party whose advice might be useful, such as the entity's legal counsel.

.65 If, after discusssing the matter as described in paragraph .64, the accountant concludes that a material misstatement of fact remains, the action he takes will depend on his judgment in the particular circumstances. He should consider steps such as notifying the responsible party in writing of his views concerning the information and consulting his legal counsel about further appropriate action in the circumstances.

Effective Date

.66 This section is effective for engagements in which the date of completion of the accountant's services on prospective financial statements is September 30, 1986, or later. Earlier application is encouraged.

Appendix A *

.67 Minimum Presentation Guidelines

1. Prospective information presented in the format of historical financial statements facilitates comparisons with financial position, results of operations, and changes in financial position of prior periods, as well as those actually achieved for the prospective period. Accordingly, prospective financial statements preferably should be in the format of the historical financial statements that would be issued for the period(s) covered unless there is an agreement between the responsible party and potential users specifying another format. Prospective financial statements may take the form of complete basic financial statements [1] or may be limited to the following minimum items (where such items would be presented for historical financial statements for the period).[2]

a. Sales or gross revenues

b. Gross profit or cost of sales

c. Unusual or infrequently occurring items

d. Provision for income taxes

e. Discontinued operations or extraordinary items

f. Income from continuing operations

g. Net income

h. Primary and fully diluted earnings per share

i. Significant changes in financial position [3]

j. A description of what management intends the prospective financial statements to present, a statement that the assumptions are based on information about circumstances and conditions existing at the time the prospective information was prepared, and a caveat that the prospective results may not be achieved

k. Summary of significant assumptions

l. Summary of significant accounting policies

2. A presentation that omits one or more of the applicable minimum items *a* through *i* above is a partial presentation, which would not ordinarily be appropriate for general use. If an omitted applicable minimum item is derivable from the information presented, the presentation would not be deemed to be a partial presentation.[4] A presentation that contains the applicable minimum items *a* through *i* above, but omits minimum items *j*

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* *Note:* This appendix describes the minimum items that constitute a presentation of a financial forecast or a financial projection, as specified in the AICPA *Guide for Prospective Financial Statements.* Complete presentation guidelines for entities that choose to issue prospective financial statements, together with illustrative presentations, are included in the guide.

[1] The details of each statement may be summarized or condensed so that only the major items in each are presented. The usual footnotes associated with historical financial statements need not be included as such. However, significant assumptions and accounting policies should be disclosed.

[2] Similar types of financial information should be presented for entities for which these terms do not describe operations. Further, similar items should be presented if a comprehensive basis of accounting other than generally accepted accounting principles is used to present the prospective financial statements. For example, if the cash basis were used, item a would be cash receipts.

[3] This item does not require a balance sheet or a statement of changes in financial position. Examples are included in the AICPA *Guide for Prospective Financial Statements.*

[4] Footnote deleted.

through *l* above is not a partial presentation, and an engagement involving such a presentation is subject to the provisions of this section.

Appendix B

.68 Training and Proficiency, Planning and Procedures Applicable to Compilations

Training and Proficiency

1. The accountant should be familiar with the guidelines for the preparation and presentation of prospective financial statements. The guidelines are contained in the AICPA *Guide for Prospective Financial Statements.*

2. The accountant should possess or obtain a level of knowledge of the industry and the accounting principles and practices of the industry in which the entity operates, or will operate, that will enable him to compile prospective financial statements that are in appropriate form for an entity operating in that industry.

Planning the Compilation Engagement

3. To compile the prospective financial statements of an existing entity, the accountant should obtain a general knowledge of the nature of the entity's business transactions and the key factors upon which its future financial results appear to depend. He should also obtain an understanding of the accounting principles and practices of the entity to determine if they are comparable to those used within the industry in which the entity operates.

4. To compile the prospective financial statements of a proposed entity, the accountant should obtain knowledge of the proposed operations and the key factors upon which its future results appear to depend and that have affected the performance of entities in the same industry.

Compilation Procedures

5. In performing a compilation of prospective financial statements the accountant should, where applicable—

a. Establish an understanding with the client, preferably in writing, regarding the services to be performed.

b. Inquire about the accounting principles used in the preparation of the prospective financial statements.

- For existing entities, compare the accounting principles used to those used in the preparation of previous historical financial statements and inquire whether such principles are the same as those expected to be used in the historical financial statements covering the prospective period.

- For entities to be formed or entities formed that have not commenced operations, compare specialized industry accounting principles used, if any, to those typically used in the industry. Inquire about whether the accounting principles used for the prospective financial statements are those that are expected to be used when, or if, the entity commences operations.

c. Ask how the responsible party identifies the key factors and develops its assumptions.

d. List, or obtain a list of, the responsible party's significant assumptions providing the basis for the prospective financial statements and consider whether there are any obvious omissions in light of the key factors upon which the prospective results of the entity appear to depend.

e. Consider whether there appear to be any obvious internal inconsistencies in the assumptions.

f. Perform, or test the mathematical accuracy of, the computations that translate the assumptions into prospective financial statements.

g. Read the prospective financial statements, including the summary of significant assumptions, and consider whether—

● The statements, including the disclosures of assumptions and accounting policies, appear to be not presented in conformity with the AICPA presentation guidelines for prospective financial statements.[1]

● The statements, including the summary of significant assumptions, appear to be not obviously inappropriate in relation to the accountant's knowledge of the entity and its industry and, for a—

Financial forecast, the expected conditions and course of action in the prospective period.

Financial projection, the purpose of the presentation.

h. If a significant part of the prospective period has expired, inquire about the results of operations or significant portions of the operations (such as sales volume), and significant changes in financial position, and consider their effect in relation to the prospective financial statements. If historical financial statements have been prepared for the expired portion of the period, the accountant should read such statements and consider those results in relation to the prospective financial statements.

i. Confirm his understanding of the statements (including assumptions) by obtaining written representations from the responsible party. Because the amounts reflected in the statements are not supported by historical books and records but rather by assumptions, the accountant should obtain representations in which the responsible party indicates its responsibility for the assumptions. The representations should be signed by the responsible party at the highest level of authority who the accountant believes is responsible for and knowledgeable, directly or through others, about matters covered by the representations.

● *For a financial forecast,* the representations should include a statement that the financial forecast presents, to the best of the responsible party's knowledge and belief, the expected financial position, results of operations, and changes in financial position for the forecast period and that the forecast reflects the responsible party's judgment, based on present circumstances, of the expected conditions and its expected course of action. If the forecast contains a range, the representation should also include a statement that, to the best of the responsible party's knowledge and belief, the item or items subject to the assumption are expected to actually fall within the range and that the range was not selected in a biased or misleading manner.

● *For a financial projection,* the representations should include a statement that the financial projection presents, to the best of the responsible party's knowledge and belief, the expected financial

[1] Presentation guidelines for entities that issue prospective financial statements are set forth and illustrated in the AICPA *Guide for Prospective Financial Statements.*

position, results of operations, and changes in financial position for the projection period given the hypothetical assumptions, and that the projection reflects its judgment, based on present circumstances, of expected conditions and its expected course of action given the occurrence of the hypothetical events. The representations should also (i) identify the hypothetical assumptions and describe the limitations on the usefulness of the presentation, (ii) state that the assumptions are appropriate, (iii) indicate if the hypothetical assumptions are improbable, and (iv) if the projection contains a range, include a statement that, to the best of the responsible party's knowledge and belief, given the hypothetical assumptions, the item or items subject to the assumption are expected to actually fall within the range and that the range was not selected in a biased or misleading manner.

j. Consider, after applying the above procedures, whether he has received representations or other information that appears to be obviously inappropriate, incomplete, or otherwise misleading and, if so, attempt to obtain additional or revised information. If he does not receive such information, the accountant should ordinarily withdraw from the compilation engagement.[2] (Note that the omission of disclosures, other than those relating to significant assumptions, would not require the accountant to withdraw; see paragraph .24 of this section.)

[2] The accountant need not withdraw from the engagement if the effect of such information on the prospective financial statements does not appear to be material.

Appendix C

.69 Training and Proficiency, Planning and Procedures Applicable to Examinations

Training and Proficiency

1. The accountant should be familiar with the guidelines for the preparation and presentation of prospective financial statements. The guidelines are contained in the AICPA *Guide for Prospective Financial Statements.*

2. The accountant should possess or obtain a level of knowledge of the industry and the accounting principles and practices of the industry in which the entity operates, or will operate, that will enable him to examine prospective financial statements that are in appropriate form for an entity operating in that industry.

Planning an Examination Engagement

3. Planning the examination engagement involves developing an overall strategy for the expected scope and conduct of the engagement. To develop such a strategy, the accountant needs to have sufficient knowledge to enable him to adequately understand the events, transactions, and practices that, in his judgment, may have a significant effect on the prospective financial statements.

4. Factors to be considered by the accountant in planning the examination include (a) the accounting principles to be used and the type of presentation, (b) the anticipated level of attestation risk [1] related to the prospective financial statements, (c) preliminary judgments about materiality levels, (d) items within the prospective financial statements that are likely to require revision or adjustment, (e) conditions that may require extension or modification of the accountant's examination procedures, (f) knowledge of the entity's business and its industry, (g) the responsible party's experience in preparing prospective financial statements, (h) the length of the period covered by the prospective financial statements, and (i) the process by which the responsible party develops its prospective financial statements.

5. The accountant should obtain knowledge of the entity's business, accounting principles, and the key factors upon which its future financial results appear to depend. The accountant should focus on such areas as—

a. The availability and cost of resources needed to operate. Principal items usually include raw materials, labor, short-term and long-term financing, and plant and equipment.

b. The nature and condition of markets in which the entity sells its goods or services, including final consumer markets if the entity sells to intermediate markets.

c. Factors specific to the industry, including competitive conditions, sensitivity to economic conditions, accounting policies, specific regulatory requirements, and technology.

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[1] *Attestation risk* is the risk that the accountant may unknowingly fail to appropriately modify his examination report on prospective financial statements that are materially misstated, that is, that are not presented in conformity with AICPA presentation guidelines or have assumptions that do not provide a reasonable basis for management's forecast, or management's projection given the hypothetical assumptions. It consists of (a) the risk (consisting of inherent risk and control risk) that the prospective financial statements contain errors that could be material and (b) the risk (detection risk) that the accountant will not detect such errors.

d. Patterns of past performance for the entity or comparable entities, including trends in revenue and costs, turnover of assets, uses and capacities of physical facilities, and management policies.

Examination Procedures

6. The accountant and the responsible party should reach an understanding regarding the services to be provided. Ordinarily, this understanding is confirmed in an engagement letter.

7. The accountant's objective in an examination of prospective financial statements is to accumulate sufficient evidence to limit attestation risk to a level that is, in his professional judgment, appropriate for the level of assurance that may be imparted by his examination report. In a report on an examination of prospective financial statements, he provides assurance only about whether the prospective financial statements are presented in conformity with AICPA presentation guidelines and whether the assumptions provide a reasonable basis for management's forecast, or a reasonable basis for management's projection given the hypothetical assumptions. He does not provide assurance about the achievability of the prospective results because events and circumstances frequently do not occur as expected and achievement of the prospective results is dependent on the actions, plans, and assumptions of the responsible party.

8. In his examination of prospective financial statements, the accountant should select from all available procedures—that is, procedures that assess inherent and control risk and restrict detection risk—any combination that can limit attestation risk to such an appropriate level. The extent to which examination procedures will be performed should be based on the accountant's consideration of (a) the nature and materiality of the information to the prospective financial statements taken as a whole; (b) the likelihood of misstatements; (c) knowledge obtained during current and previous engagements; (d) the responsible party's competence with respect to prospective financial statements; (e) the extent to which the prospective financial statements are affected by the responsible party's judgment, for example, its judgment in selecting the assumptions used to prepare the prospective financial statements; and (f) the adequacy of the responsible party's underlying data.

9. The accountant should perform those procedures he considers necessary in the circumstances to report on whether the assumptions provide a reasonable basis for the—

a. *Financial forecast.* The accountant can form an opinion that the assumptions provide a reasonable basis for the forecast if the responsible party represents that the presentation reflects, to the best of its knowledge and belief, its estimate of expected financial position, results of operations, and changes in financial position for the prospective period [2] and the accountant concludes, based on his examination, (i) that the responsible party has explicitly identified all factors expected to materially affect the operations of the entity during the prospective period and has developed appropriate assumptions with respect to such factors[3] and (ii) that the assumptions are suitably supported.

[2] If the forecast contains a range, the representation should also include a statement that, to the best of the responsible party's knowledge and belief, the item or items subject to the assumption are expected to actually fall within the range and that the range was not selected in a biased or misleading manner.

[3] An attempt to list all assumptions is inherently not feasible. Frequently, basic assumptions that have enormous potential impact are considered to be implicit, such as conditions of peace and absence of natural disasters.

b. *Financial projection* given the hypothetical assumptions. The accountant can form an opinion that the assumptions provide a reasonable basis for the financial projection given the hypothetical assumptions if the responsible party represents that the presentation reflects, to the best of its knowledge and belief, expected financial position, results of operations, and changes in financial position for the prospective period given the hypothetical assumptions[4] and the accountant concludes, based on his examination, (i) that the responsible party has explicitly identified all factors that would materially affect the operations of the entity during the prospective period if the hypothetical assumptions were to materialize and has developed appropriate assumptions with respect to such factors and (ii) that the other assumptions are suitably supported given the hypothetical assumptions. However, as the number and significance of the hypothetical assumptions increase, the accountant may not be able to satisfy himself about the presentation as a whole by obtaining support for the remaining assumptions.

10. The accountant should evaluate the support for the assumptions.

a. *Financial forecast*—The accountant can conclude that assumptions are suitably supported if the preponderance of information supports each significant assumption.

b. *Financial projection*—In evaluating support for assumptions other than hypothetical assumptions, the accountant can conclude that they are suitably supported if the preponderance of information supports each significant assumption given the hypothetical assumptions. The accountant need not obtain support for the hypothetical assumptions, although he should consider whether they are consistent with the purpose of the presentation.

11. In evaluating the support for assumptions, the accountant should consider—

a. Whether sufficient pertinent sources of information about the assumptions have been considered. Examples of external sources the accountant might consider are government publications, industry publications, economic forecasts, existing or proposed legislation, and reports of changing technology. Examples of internal sources are budgets, labor agreements, patents, royalty agreements and records, sales backlog records, debt agreements, and actions of the board of directors involving entity plans.

b. Whether the assumptions are consistent with the sources from which they are derived.

c. Whether the assumptions are consistent with each other.

d. Whether the historical financial information and other data used in developing the assumptions are sufficiently reliable for that purpose. Reliability can be assessed by inquiry and analytical or other procedures, some of which may have been completed in past examinations or reviews of the historical financial statements. If historical financial statements have been prepared for an expired part of the prospective period, the accountant should consider the historical

[4] If the projection contains a range, the representation should also include a statement that, to the best of the responsible party's knowledge and belief, given the hypothetical assumptions, the item or items subject to the assumption are expected to actually fall within the range and that the range was not selected in a biased or misleading manner.

data in relation to the prospective results for the same period, where applicable. If the prospective financial statements incorporate such historical financial results and that period is significant to the presentation, the accountant should make a review of the historical information in conformity with the applicable standards for a review.[5]

e. Whether the historical financial information and other data used in developing the assumptions are comparable over the periods specified or whether the effects of any lack of comparability were considered in developing the assumptions.

f. Whether the logical arguments or theory, considered with the data supporting the assumptions, are reasonable.

12. In evaluating the preparation and presentation of the prospective financial statements, the accountant should perform procedures that will provide reasonable assurance that the—

a. Presentation reflects the identified assumptions.

b. Computations made to translate the assumptions into prospective amounts are mathematically accurate.

c. Assumptions are internally consistent.

d. Accounting principles used in the—

- *Financial forecast* are consistent with the accounting principles expected to be used in the historical financial statements covering the prospective period and those used in the most recent historical financial statements, if any.

- *Financial projection* are consistent with the accounting principles expected to be used in the prospective period and those used in the most recent historical financial statements, if any, or that they are consistent with the purpose of the presentation.[6]

e. Presentation of the prospective financial statements follows the AICPA guidelines applicable for such statements.[7]

f. Assumptions have been adequately disclosed based on AICPA presentation guidelines for prospective financial statements.

13. The accountant should consider whether the prospective financial statements, including related disclosures, should be revised because of (a) mathematical errors, (b) unreasonable or internally inconsistent assumptions, (c) inappropriate or incomplete presentation, or (d) inadequate disclosure.

14. The accountant should obtain written representations from the responsible party acknowledging its responsibility for both the presentation and the underlying assumptions. The representations should be signed by the responsible party at the highest level of authority who the accountant believes is responsible for and knowledgeable, directly or through others in the organization, about the matters covered by the representations. Paragraph .68, paragraph 5*i* describes the specific representations to be obtained for a financial forecast and a financial projection.

[The next page is 2701.]

[5] If the entity is a public company, the accountant should perform the procedures in AU section 722, *Interim Financial Information,* paragraphs .13 through .19. If the entity is nonpublic, the accountant should perform the procedures in SSARS No. 1, *Compilation and Review of Financial Statements,* paragraphs 24 through 31 [AR section 100.24—.31]. [Reference changed by the issuance of Statement on Auditing Standards No. 71.]

[6] The accounting principles used in a financial projection need not be those expected to be used in the historical financial statements for the prospective period if use of different principles is consistent with the purpose of the presentation.

[7] Presentation guidelines for entities that issue prospective financial statements are set forth and illustrated in the AICPA *Guide for Prospective Financial Statements.*

AT Section 300

Reporting on Pro Forma Financial Information

Source: SSAE No. 1.

Effective for reports on an examination or a review of pro forma financial information issued on or after November 1, 1988, unless otherwise indicated.

.01 This section provides guidance to an accountant who is engaged to examine or review and report on pro forma financial information. Such an engagement should comply with the general and fieldwork standards set forth in the Statement on Standards for Attestation Engagements, *Attestation Standards* [section 100], and the specific performance and reporting standards set forth in this statement.[1]

.02 When pro forma financial information is presented outside the basic financial statements but within the same document, and the accountant is not engaged to report on the pro forma financial information, the accountant's responsibilities are described in AU section 550, *Other Information in Documents Containing Audited Financial Statements, and* AU section 711, *Filings Under Federal Securities Statutes.*

.03 This section does not apply in those circumstances when, for purposes of a more meaningful presentation, a transaction consummated after the balance sheet date is reflected in the historical financial statements (such as a revision of debt maturities or a revision of earnings per share calculations for a stock split).[2]

Presentation of Pro Forma Financial Information

.04 The objective of pro forma financial information is to show what the significant effects on historical financial information might have been had a consummated or proposed transaction (or event) occurred at an earlier date. Pro forma financial information is commonly used to show the effects of transactions such as a—

- Business combination.
- Change in capitalization.
- Disposition of a significant portion of business.

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[1] Accountants engaged to apply agreed-upon procedures to pro forma financial information should refer to the guidance in the *Attestation Standards* [section 100].

[2] In certain circumstances, generally accepted accounting principles may require the presentation of pro forma financial information in the financial statements or accompanying notes. That information includes, for example, pro forma financial information required by APB Opinion 16, *Business Combinations* (paragraphs 61, 65, and 96 [AC B50.120, .124, and .165]); APB Opinion 20, *Accounting Changes* (paragraph 21 [AC A06.117]); or, in some cases, pro forma financial information relating to subsequent events (see AU section 560.05). For guidance in reporting on audited financial statements that include pro forma financial information for a business combination or subsequent event, see AU section 508, *Reports on Audited Financial Statements,* paragraph .46.

- Change in the form of business organization or status as an autonomous entity.
- Proposed sale of securities and the application of proceeds.

.05 This objective is achieved primarily by applying pro forma adjustments to historical financial information. Pro forma adjustments should be based on management's assumptions and give effect to all significant effects directly attributable to the transaction (or event).

.06 Pro forma financial information should be labeled as such to distinguish it from historical financial information. This presentation should describe the transaction (or event) that is reflected in the pro forma financial information, the source of the historical financial information on which it is based, the significant assumptions used in developing the pro forma adjustments, and any significant uncertainties about those assumptions. The presentation also should indicate that the pro forma financial information should be read in conjunction with related historical financial information and that the pro forma financial information is not necessarily indicative of the results (such as financial position and results of operations, as applicable) that would have been attained had the transaction (or event) actually taken place earlier.[3]

Conditions for Reporting

.07 The accountant may agree to report on an examination or a review of pro forma financial information if the following conditions are met:

a. The document that contains the pro forma financial information includes (or incorporates by reference) complete historical financial statements of the entity for the most recent year (or for the preceding year if financial statements for the most recent year are not yet available) and, if pro forma financial information is presented for an interim period, the document also includes (or incorporates by reference) historical interim financial information for that period (which may be presented in condensed form).[4] In the case of a business combination, the document should include (or incorporate by reference) the appropriate historical financial information for the significant constituent parts of the combined entity.

b. The historical financial statements of the entity (or, in the case of a business combination, of each significant constituent part of the combined entity) on which the pro forma financial information is based have been audited or reviewed.[5] The accountant's attestation risk relating to the pro forma financial information is affected by the scope of the engagement providing the accountant with assurance about the underlying historical financial information to which the pro forma adjustments are applied. Therefore, the level of assurance given by the accountant on the pro forma financial information, as of a particular date or for a particular period, should be limited to the level of assurance provided on the historical financial statements (or, in the case of a business combination, the

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[3] For further guidance on the presentation of pro forma financial information included in filings with the Securities and Exchange Commission (SEC), see Article 11 of Regulation S-X.

[4] For pro forma financial information included in an SEC Form 8-K, historical financial information previously included in an SEC filing would meet this requirement. Interim historical financial information may be presented as a column in the pro forma financial information.

[5] The accountant's audit or review report should be included (or incorporated by reference) in the document containing the pro forma financial information. The review may be that as defined in AU section 722, *Interim Financial Information,* for public companies, or as defined in Statement on Standards for Accounting and Review Services 1, *Compilation and Review of Financial Statements* [AR section 100], for nonpublic companies.

lowest level of assurance provided on the underlying historical financial statements of any significant constituent part of the combined entity). For example, if the underlying historical financial statements of each significant constituent part of the combined entity have been audited at year end and reviewed at an interim date, the accountant may perform an examination or a review of the pro forma financial information at year end but is limited to performing a review of the pro forma financial information at the interim date.

c. The accountant who is reporting on the pro forma financial information should have an appropriate level of knowledge of the accounting and financial reporting practices of each significant constituent part of the combined entity. This would ordinarily have been obtained by the accountant auditing or reviewing historical financial statements of each entity for the most recent annual or interim period for which the pro forma financial information is presented. If another accountant has performed such an audit or a review, the need, by the accountant reporting on the pro forma financial information, for an understanding of the entity's accounting and financial reporting practices is not diminished, and that accountant should consider whether, under the particular circumstances, he or she can acquire sufficient knowledge of these matters to perform the procedures necessary to report on the pro forma financial information.

Accountant's Objective

.08 The objective of the accountant's examination procedures applied to pro forma financial information is to provide reasonable assurance as to whether—

- Management's assumptions provide a reasonable basis for presenting the significant effects directly attributable to the underlying transaction (or event).
- The related pro forma adjustments give appropriate effect to those assumptions.
- The pro forma column reflects the proper application of those adjustments to the historical financial statements.

.09 The objective of the accountant's review procedures applied to pro forma financial information is to provide negative assurance as to whether any information came to the accountant's attention to cause him or her to believe that—

- Management's assumptions do not provide a reasonable basis for presenting the significant effects directly attributable to the transaction (or event).
- The related pro forma adjustments do not give appropriate effect to those assumptions.
- The pro forma column does not reflect the proper application of those adjustments to the historical financial statements.

Procedures

.10 Other than the procedures applied to the historical financial statements,[6] the procedures the accountant should apply to the assumptions and pro forma adjustments for either an examination or a review engagement are as follows:

a. Obtain an understanding of the underlying transaction (or event), for example, by reading relevant contracts and minutes of meetings of the board of directors and by making inquiries of appropriate officials of the entity, and, in some cases, of the entity acquired or to be acquired.

b. Obtain a level of knowledge of each significant constituent part of the combined entity in a business combination that will enable the accountant to perform the required procedures. Procedures to obtain this knowledge may include communicating with other accountants who have audited or reviewed the historical financial information on which the pro forma financial information is based. Matters that may be considered include accounting principles and financial reporting practices followed, transactions between the entities, and material contingencies.

c. Discuss with management their assumptions regarding the effects of the transaction (or event).

d. Evaluate whether pro forma adjustments are included for all significant effects directly attributable to the transaction (or event).

e. Obtain sufficient evidence in support of such adjustments. The evidence required to support the level of assurance given is a matter of professional judgment. The accountant typically would obtain more evidence in an examination engagement than in a review engagement. Examples of evidence that the accountant might consider obtaining are purchase, merger or exchange agreements, appraisal reports, debt agreements, employment agreements, actions of the board of directors, and existing or proposed legislation or regulatory actions.

f. Evaluate whether management's assumptions that underlie the pro forma adjustments are presented in a sufficiently clear and comprehensive manner. Also, evaluate whether the pro forma adjustments are consistent with each other and with the data used to develop them.

g. Determine that computations of pro forma adjustments are mathematically correct and that the pro forma column reflects the proper application of those adjustments to the historical financial statements.

h. Obtain written representations from management concerning their—

- Responsibility for the assumptions used in determining the pro forma adjustments.
- Belief that the assumptions provide a reasonable basis for presenting all of the significant effects directly attributable to the transaction (or event), that the related pro forma adjust-

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[6] See paragraph .07(*b*).

ments give appropriate effect to those assumptions, and that the pro forma column reflects the proper application of those adjustments to the historical financial statements.

- Belief that the significant effects directly attributable to the transaction (or event) are appropriately disclosed in the pro forma financial information.

i. Read the pro forma financial information and evaluate whether—

- The underlying transaction (or event), the pro forma adjustments, the significant assumptions and the significant uncertainties, if any, about those assumptions have been appropriately described.
- The source of the historical financial information on which the pro forma financial information is based has been appropriately identified.

Reporting on Pro Forma Financial Information

.11 The accountant's report on pro forma financial information should be dated as of the completion of the appropriate procedures. The accountant's report on pro forma financial information may be added to the accountant's report on historical financial information, or it may appear separately. If the reports are combined and the date of completion of the procedures for the examination or review of the pro forma financial information is after the date of completion of the fieldwork for the audit or review of the historical financial information, the combined report should be dual-dated. (For example, "February 15, 19X2, except for the paragraphs regarding pro forma financial information as to which the date is March 20, 19X2.")

.12 An accountant's report on pro forma financial information should include—

a. An identification of the pro forma financial information.

b. A reference to the financial statements from which the historical financial information is derived and a statement as to whether such financial statements were audited or reviewed. The report on pro forma financial information should refer to any modification in the accountant's report on the historical financial statements.

c. A statement that the examination or review of the pro forma financial information was made in accordance with standards established by the American Institute of Certified Public Accountants. If a review is performed, the report should include the following statement:

A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the pro forma financial information. Accordingly, we do not express such an opinion.

d. A separate paragraph explaining the objective of pro forma financial information and its limitations.

e. (1) If an examination of pro forma financial information has been performed, the accountant's opinion as to whether management's assumptions provide a reasonable basis for presenting the significant effects directly attributable to the transaction (or event), whether the related pro forma adjustments give appropriate effect to those assumptions, and whether the pro forma column reflects the proper application of those adjustments to the historical financial statements (see paragraphs .16 and .18).

(2) If a review of pro forma financial information has been performed, the accountant's conclusion as to whether any information came to the accountant's attention to cause him or her to believe that management's assumptions do not provide a reasonable basis for presenting the significant effects directly attributable to the transaction (or event), or that the related pro forma adjustments do not give appropriate effect to those assumptions, or that the pro forma column does not reflect the proper application of those adjustments to the historical financial statements (see paragraphs .17 and .18).

.13 Because a pooling-of-interests business combination is accounted for by combining historical amounts retroactively, pro forma adjustments for a proposed transaction generally affect only the equity section of the pro forma condensed balance sheet. Further, because of the requirements of the Accounting Principles Board Opinion No. 16, *Business Combinations* [AC B50], a business combination effected as a pooling of interests would not ordinarily involve a choice of assumptions by management. Accordingly, a report on a proposed pooling transaction need not address management's assumptions unless the pro forma financial information includes adjustments to conform the accounting principles of the combining entities (see paragraph .19).

.14 Restrictions on the scope of the engagement, significant uncertainties about the assumptions that could materially affect the transaction (or event), reservations about the propriety of the assumptions and the conformity of the presentation with those assumptions (including inadequate disclosure of significant matters), or other reservations may require the accountant to qualify the opinion, render an adverse opinion, disclaim an opinion or withdraw from the engagement.[7] The accountant should disclose all substantive reasons for any report modifications. Uncertainty as to whether the transaction (or event) will be consummated would not ordinarily require a report modification (see paragraph .20).

Effective Date

.15 This section is effective for reports on an examination or a review of pro forma financial information issued on or after November 1, 1988. Earlier application of the provisions of this section is permissible.

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[7] See paragraph 66 of the SSAE, *Attestation Standards* [section 100.66].

Examples of Reports on Pro Forma Financial Information

Appendix A

.16 Report on Examination of Pro Forma Financial Information

We have examined the pro forma adjustments reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*][8] the accompanying pro forma condensed balance sheet of X Company as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended. The historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were audited by other accountants,[9] appearing elsewhere herein [*or incorporated by reference*].[10] Such pro forma adjustments are based upon management's assumptions described in Note 2. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.

The objective of this pro forma financial information is to show what the significant effects on the historical financial information might have been had the transaction [*or event*] occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction [*or event*] actually occurred earlier.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement.*]

In our opinion, management's assumptions provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, the related pro forma adjustments give appropriate effect to those assumptions, and the pro forma column reflects the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended.

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[8] This wording is appropriate when one column of pro forma financial information is presented without separate columns of historical financial information and pro forma adjustments.

[9] If either accountant's report includes an explanatory paragraph or is other than unqualified, that fact should be referred to within this report.

[10] If the option in footnote 4 to paragraph .07*a* is followed, the report should be appropriately modified.

Appendix B

.17 Report on Review of Pro Forma Financial Information

We have reviewed the pro forma adjustments reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*][11] the accompanying pro forma condensed balance sheet of X Company as of March 31, 19X2, and the pro forma condensed statement of income for the three months then ended. These historical condensed financial statements are derived from the historical unaudited financial statements of X Company, which were reviewed by us, and of Y Company, which were reviewed by other accountants,[12, 13] appearing elsewhere herein [*or incorporated by reference*].[14] Such pro forma adjustments are based on management's assumptions as described in Note 2. Our review was conducted in accordance with standards established by the American Institute of Certified Public Accountants.

A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's assumptions, the pro forma adjustments and the application of those adjustments to historical financial information. Accordingly, we do not express such an opinion.

The objective of this pro forma financial information is to show what the significant effects on the historical information might have been had the transaction [*or event*] occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction [*or event*] actually occurred earlier.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement.*]

Based on our review, nothing came to our attention that caused us to believe that management's assumptions do not provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, that the related pro forma adjustments do not give appropriate effect to those assumptions, or that the pro forma column does not reflect the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of March 31, 19X2, and the pro forma condensed statement of income for the three months then ended.

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[11] This wording is appropriate when one column of pro forma financial information is presented without separate columns of historical financial information and pro forma adjustments.

[12] If either accountant's report includes an explanatory paragraph or is modified, that fact should be referred to within this report.

[13] Where one set of historical financial statements is audited and the other set is reviewed, wording similar to the following would be appropriate:

> The historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were reviewed by other accountants, appearing elsewhere herein [*or incorporated by reference*].

[14] If the option in footnote 4 to paragraph .07*a* is followed, the report should be appropriately modified.

Appendix C

.18 Report on Examination of Pro Forma Financial Information at Year End With a Review of Pro Forma Financial Information for a Subsequent Interim Date

We have examined the pro forma adjustments reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*][15] the accompanying pro forma condensed balance sheet of X Company as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended. The historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were audited by other accountants,[16] appearing elsewhere herein [*or incorporated by reference*].[17] Such pro forma adjustments are based upon management's assumptions described in Note 2. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.

In addition, we have reviewed the related pro forma adjustments and the application of those adjustments to the historical amounts in [*the assembly of*][15] the accompanying pro forma condensed balance sheet of X Company as of March 31, 19X2, and the pro forma condensed statement of income for the three months then ended. The historical condensed financial statements are derived from the historical financial statements of X Company, which were reviewed by us, and Y Company, which were reviewed by other accountants,[18] appearing elsewhere herein [*or incorporated by reference*].[17] Such pro forma adjustments are based upon management's assumptions described in Note 2. Our review was made in accordance with standards established by the American Institute of Certified Public Accountants.

The objective of this pro forma financial information is to show what the significant effects on the historical information might have been had the transaction [*or event*] occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction [*or event*] actually occurred earlier.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagements.*]

In our opinion, management's assumptions provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, the related pro forma adjustments

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[15] This wording is appropriate when one column of pro forma financial information is presented without separate columns of historical financial information and pro forma adjustments.

[16] If either accountant's report includes an explanatory paragraph or is other than unqualified, that fact should be referred to within this report.

[17] If the option in footnote 4 to paragraph .07*a* is followed, the report should be appropriately modified.

[18] Where one set of historical financial statements is audited and the other set is reviewed, wording similar to the following would be appropriate:

> The historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were reviewed by other accountants, appearing elsewhere herein [*or incorporated by reference*].

give appropriate effect to those assumptions, and the pro forma column reflects the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended.

A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's assumptions, the pro forma adjustments and the application of those adjustments to historical financial information. Accordingly, we do not express such an opinion on the pro forma adjustments or the application of such adjustments to the pro forma condensed balance sheet as of March 31, 19X2, and the pro forma condensed statement of income for the three months then ended. Based on our review, however, nothing came to our attention that caused us to believe that management's assumptions do not provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, that the related pro forma adjustments do not give appropriate effect to those assumptions, or that the pro forma column does not reflect the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balanced sheet as of March 31, 19X2, and the pro forma condensed statement of income for the three months then ended.

Appendix D

.19 Report on Examination of Pro Forma Financial Information Giving Effect to a Business Combination to be Accounted for as a Pooling of Interests

We have examined the pro forma adjustments reflecting the proposed business combination to be accounted for as a pooling of interests described in Note 1 and the application of those adjustments to the historical amounts in the accompanying pro forma condensed balance sheet of X Company as of December 31, 19X1, and the pro forma condensed statements of income for each of the three years in the period then ended. These historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us,[19] and of Y Company, which were audited by other accountants, appearing elsewhere herein [*or incorporated by reference*].[20] Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances.

The objective of this pro forma financial information is to show what the significant effects on the historical information might have been had the proposed transaction occurred at an earlier date.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement.*]

In our opinion, the accompanying condensed pro forma financial statements of X Company as of December 31, 19X1, and for each of the three years in the period then ended give appropriate effect to the pro forma adjustments necessary to reflect the proposed business combination on a pooling of interests basis as described in Note 1 and the pro forma column reflects the proper application of those adjustments to the historical financial statements.

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[19] If either accountant's report includes an explanatory paragraph or is other than unqualified, that fact should be referred to within this report.

[20] If the option in footnote 4 to paragraph .07*a* is followed, the report should be appropriately modified.

Appendix E

.20 Other Example Reports

An example of a report qualified because of a scope limitation follows:

> We have examined the pro forma adjustments reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*][21] the accompanying pro forma condensed balance sheet of X Company as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended. The historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were audited by other accountants,[22] appearing elsewhere herein [*or incorporated by reference*].[23] Such pro forma adjustments are based upon management's assumptions described in Note 2. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances, except as explained in the following paragraphs.
>
> We are unable to perform the examination procedures we considered necessary with respect to assumptions relating to the proposed loan described as Adjustment E in Note 2.
>
> [*Same paragraph as second paragraph in examination report in paragraph .16*]
>
> In our opinion, except for the effects of such changes, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to the assumptions relating to the proposed loan, management's assumptions provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, the related pro forma adjustments give appropriate effect to those assumptions, and the pro forma column reflects the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended.

An example of a report modified because of an uncertainty follows:

> [*Same first and second paragraphs as examination report in paragraph .16*]
>
> In our opinion, management's assumptions provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction described in Note 1, the related pro forma adjustments give appropriate effect to those assumptions, and the pro forma column reflects the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended.
>
> It has been assumed that the transaction described in Note 1 is nontaxable. Such determination is dependent on an Internal Revenue Service (IRS) ruling that has been requested but not yet received by management. The ultimate decision by the IRS cannot be determined at this time.

An example of a report qualified for reservations about the propriety of assumptions on an acquisition transaction follows:

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[21] This wording is appropriate when one column of pro forma financial information is presented without separate columns of historical financial information and pro forma adjustments.

[22] If either accountant's report includes an explanatory paragraph or is other than unqualified, that fact should be referred to within this report.

[23] If the option in footnote 4 to paragraph .07*a* is followed, the report should be appropriately modified.

[*Same first and second paragraphs examination report in paragraph .16*]

As discussed in Note 2 to the pro forma financial statements, the pro forma adjustments reflect management's assumption that X Division of the acquired company will be sold. The net assets of this division are reflected at their historical carrying amount; generally accepted accounting principles require these net assets to be recorded at estimated net realizable value.

In our opinion, except for inappropriate valuation of the net assets of X Division, management's assumptions described in Note 2 provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, the related pro forma adjustments give appropriate effect to those assumptions, and the pro forma column reflects the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended.

An example of a disclaimer of opinion because of a scope limitation follows:

We were engaged to examine the pro forma adjustments reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*] [24] the accompanying pro forma condensed balance sheet of X Company as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended. The historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us,[25] and of Y Company which were audited by other accountants, appearing elsewhere herein [*or incorporated by reference*].[26] Such pro forma adjustments are based upon management's assumptions described in Note 2.

As discussed in Note 2 to the pro forma financial statements, the pro forma adjustments reflect the management's assumptions that the elimination of duplicate facilities would have resulted in a 30 percent reduction in operating costs. Management could not supply us with sufficient evidence to support this assertion.

[*Same paragraph as second paragraph in examination report in paragraph .16*]

Since we were unable to evaluate management's assumptions regarding the reduction in operating costs and other assumptions related thereto, the scope of our work was not sufficient to express and, therefore, we do not express an opinion on the pro forma adjustments, management's underlying assumptions regarding those adjustments and the application of those adjustments to the historical financial statement amounts in pro forma condensed financial statement amounts in the pro forma condensed balance sheet as of December 31, 19X1, and the pro forma condensed statement of income for the year then ended.

[The next page is 2731.]

[24] See footnote 21.
[25] See footnote 22.
[26] See footnote 23.

AT Section 400

Reporting on an Entity's Internal Control Structure Over Financial Reporting

(Supersedes AU section 642)

Source: SSAE No. 2

Effective for an examination of management's assertion on the effectiveness of an entity's internal control structure over financial reporting when the assertion is as of December 15, 1993 or thereafter.

> *In January 1989, the Statements on Standards for Attestation Engagements (SSAE)* Attestation Standards *(AT section 100),* Financial Forecasts and Projections *(AT section 200), and* Reporting on Pro Forma Financial Information *(AT section 300), were codified in* Codification of Statements on Standards for Attestation Engagements. *In April 1993, the codified sections became SSAE No. 1,* Attestation Standards. *This section, therefore, becomes SSAE No. 2,* Reporting on an Entity's Internal Control Structure Over Financial Reporting.

Applicability

.01 This section provides guidance to the practitioner who is engaged to examine and report on management's written assertion about the effectiveness of an entity's internal control structure over financial reporting[1] as of a point in time.[2] Specifically, guidance is provided regarding the following:

a. Conditions that must be met for a practitioner to examine and report on management's assertion about the effectiveness of an entity's internal control structure (paragraph .10); the prohibition of acceptance of an engagement to review and report on such a management assertion (paragraph .06)

b. Engagements to examine and report on management's assertion about the design and operating effectiveness of an entity's internal control structure (paragraphs .19 through .71)

[1] This section does not change the auditor's responsibility for considering the entity's internal control structure in an audit of the financial statements. See paragraphs .84 through .87 of this section.

[2] Ordinarily, management will present its assertion about the effectiveness of the entity's internal control structure over financial reporting as of the end of the entity's fiscal year; however, management may select a different date for its assertion. A practitioner may also be engaged to examine and report on management's assertion about the effectiveness of an entity's internal control structure during a period of time. In that case, the guidance in this section should be modified accordingly.

c. Engagements to examine and report on management's assertion about the design and operating effectiveness of a segment of an entity's internal control structure (paragraph .72)

d. Engagements to examine and report on management's assertion about only the suitability of design of an entity's internal control structure (no assertion is made about the operating effectiveness of the internal control structure) (paragraphs .73 and .74)

e. Engagements to examine and report on management's assertion about the design and operating effectiveness of an entity's internal control structure based on criteria established by a regulatory agency (paragraphs .75 through .79)

This section does *not* provide guidance for the following:

a. Engagements to examine and report on management's assertion about controls over operations or compliance with laws and regulations[3]

b. Agreed-upon procedures engagements (except as noted in paragraphs .05 and .09)

c. Certain other services in connection with an entity's internal control structure covered by other authoritative guidance (paragraph .07 and the appendix [paragraph .90])

d. Consulting engagements (paragraph .08)

e. Engagements to gather data for management (paragraphs .11 and .24)

.02 An entity's internal control structure over financial reporting[4] includes those policies and procedures that pertain to an entity's ability to record, process, summarize, and report financial data consistent with the assertions embodied in either annual financial statements or interim financial statements, or both. A practitioner engaged to examine and report on management's assertion about the effectiveness of an entity's internal control structure should comply with the general, fieldwork, and reporting standards in section 100, and the specific performance and reporting standards set forth in this section.[5]

.03 Management may present its written assertion about the effectiveness of the entity's internal control structure in either of two forms:

a. A separate report that will accompany the practitioner's report

b. A representation letter to the practitioner (in this case, however, the practitioner should restrict the use of his or her report to management and others within the entity and, if applicable, to specified regulatory agencies)

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[3] A practitioner engaged to provide assurances on management's assertion about the effectiveness of an entity's internal control structure other than over financial reporting (for example, controls over safeguarding of assets other than those described in paragraph .27*c*, or other operating controls or controls over compliance with laws and regulations) should refer to the guidance in section 100. In addition, the guidance in this section may be helpful in attestation engagements to report on management's assertion about internal controls over other than financial reporting.

[4] Throughout this section, an entity's internal control structure over financial reporting is referred to as its "internal control structure."

[5] Practitioners engaged to examine and report on the design and/or operating effectiveness of the internal control structure of a service organization should refer to AU section 324, *Reports on the Processing of Transactions by Service Organizations.*

A practitioner should not consent to the use of his or her examination report on management's assertion about the effectiveness of an entity's internal control structure in a general-use document unless management presents its written assertion in a separate report that will accompany the practitioner's report.

.04 Management's written assertion about the effectiveness of an entity's internal control structure may take various forms. Throughout this section, for example, the phrase, "management's assertion that W Company maintained an effective internal control structure over financial reporting as of [*date*]," illustrates such an assertion. Other phrases, such as "management's assertion that W Company's internal control structure over financial reporting is sufficient to meet the stated objectives" may also be used. However, a practitioner should not provide assurance on an assertion that is so subjective (for example, a "very effective" internal control structure) that people having competence in and using the same or similar measurement and disclosure criteria would not ordinarily be able to arrive at similar conclusions.

Other Attest Services

.05 A practitioner may also be engaged to provide other types of services in connection with an entity's internal control structure. For example, he or she may be engaged to *perform agreed-upon procedures* relating to management's assertion about the effectiveness of the entity's internal control structure. For such engagements, the practitioner should refer to the guidance in *Attestation Standards.* However, notwithstanding the guidance set forth in *Attestation Standards*, a practitioner's report on agreed-upon procedures related to management's assertion about the effectiveness of the entity's internal control structure should be in the form of procedures and findings. The practitioner should not provide negative assurance about whether management's assertion is fairly stated.

.06 Although a practitioner may *examine* or *perform agreed-upon procedures* relating to management's assertion about the effectiveness of the entity's internal control structure, he or she should not accept an engagement to *review* and report on such a management assertion.

.07 The appendix [paragraph .90] presents a listing of authoritative guidance for a practitioner engaged to provide other services in connection with an entity's internal control structure. Under the Securities Exchange Act of 1934, certain reports on the entity's internal control structure are required. Rule 17a-5 requires such a report for a broker or dealer in securities. The American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 89-4, *Reports on the Internal Control Structure of Brokers and Dealers in Securities*, contains a sample report that a practitioner might use in such circumstances. In addition, Form N-SAR requires a report on the internal control structure of an investment company. A sample report that a practitioner might use in such situations is included in the Audit and Accounting Guide *Audits of Investment Companies*, published by the AICPA. Such information, included in the appendix [paragraph .90] to this section, in Rule 17a-5, and in Form N-SAR, is not covered by this section.

Nonattest Services

.08 Except as noted in paragraph .09, the guidance in this section does not apply if management does not present a written assertion. In this situation, there is no assertion by management on which the practitioner can provide assurance. However, management may engage the practitioner to provide certain nonattest services in connection with the entity's internal control structure. For example, management may engage the practitioner to provide recommendations on improvements to the entity's internal control structure. A practitioner engaged to provide such nonattest services should refer to the guidance in the Statement on Standards for Consulting Services [CS section 100].

.09 A practitioner may also be engaged to perform agreed-upon procedures on part of an entity's existing or proposed internal control structure when management does not present a written assertion and issue a report for the restricted use of management and, if applicable, other specified parties. The form of report in these circumstances is flexible, but should—

a. Describe the nature and extent of the procedures performed.

b. Disclaim an opinion on the effectiveness of the internal control structure or any part thereof.

c. State the practitioner's findings.

d. State that if additional procedures or an examination of the effectiveness of the entity's internal control structure had been performed, other matters might have come to the practitioner's attention that would have been reported.

e. Indicate that the report is intended solely for the information and use of management and, if applicable, the other specified parties.

As noted in paragraph .05, the practitioner should not provide negative assurance about the effectiveness of the internal control structure or any part thereof.

Conditions for Engagement Performance

.10 A practitioner may *examine* and report on management's assertion about the effectiveness of an entity's internal control structure if the following conditions are met:

a. Management accepts responsibility for the effectiveness of the entity's internal control structure.

b. Management evaluates the effectiveness of the entity's internal control structure using reasonable criteria for effective internal control structures established by a recognized body. Such criteria are referred to as "control criteria" throughout this section.[6]

c. Sufficient evidential matter exists or could be developed to support management's evaluation.

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[6] Criteria issued by the AICPA, regulatory agencies, and other bodies composed of experts that follow due process procedures, including procedures for broad distribution of proposed criteria for public comment, usually should be considered reasonable criteria for this purpose. For example, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission's report, *Internal Control—Integrated Framework*, provides reasonable criteria against which management may evaluate and report on the effectiveness of the entity's internal control structure.

Criteria established by groups that do not follow due process or groups that do not as clearly represent the public interest should be viewed more critically. The practitioner should judge whether such criteria are reasonable for general distribution reporting by evaluating them against the elements in section 100.15. If the practitioner determines that such criteria are reasonable for general distribution reporting, such criteria should be stated in the presentation of the assertion in a sufficiently clear and comprehensive manner for a reader to be able to understand them.

Some criteria are reasonable for only the parties who have participated in establishing them; for example, criteria established by a regulatory agency for its specific use. When such criteria are used, they are not suitable for general distribution reporting and the practitioner should modify his or her report by adding a paragraph that limits the report distribution to the specific parties who have participated in establishing the criteria.

d. Management presents its written assertion, as discussed in paragraph .03, about the effectiveness of the entity's internal control structure based upon the control criteria referred to in its report.

.11 Management is responsible for establishing and maintaining an effective internal control structure. In some cases, management may evaluate and report on the effectiveness of that structure without the practitioner's assistance. However, management may engage the practitioner to gather information to enable management to evaluate the effectiveness of the entity's internal control structure.

Elements of an Entity's Internal Control Structure

.12 The elements that constitute an entity's internal control structure are a function of the definition of an internal control structure selected by management. For example, management may select the definition of an internal control structure contained in AU section 319, *Consideration of the Internal Control Structure in a Financial Statement Audit*. Paragraphs .13 through .16 describe the elements that constitute an entity's internal control structure as defined in AU section 319. If management selects another definition of an internal control structure, the description of the elements contained in those paragraphs may not be relevant.

.13 AU section 319 describes an entity's internal control structure as consisting of three elements—the control environment, the accounting system, and control procedures.

.14 An entity's control environment reflects the overall attitude, awareness, and actions of the board of directors, management, owners, and others concerning the importance of control and the emphasis placed on it within the entity. It represents the collective effects of various factors, described in paragraph *.27a*, on establishing, enhancing, or mitigating the effectiveness of specific internal control structure policies and procedures. An effective control environment interacts with elements of the accounting system and with control procedures to help provide reasonable assurance that specific entity objectives are achieved.

.15 As further described in paragraph *.27b*, the entity's accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities.

.16 Control procedures are those policies and procedures in addition to the control environment and accounting system that management establishes to help ensure that specific entity objectives are met. As described in paragraph *.27c*, they have various organizational and data processing levels within an entity. They may also be integrated into specific components of the control environment and the accounting system.

Limitations of an Entity's Internal Control Structure

.17 There are inherent limitations that should be recognized when considering the effectiveness of any internal control structure. In the application of many control policies and procedures, the potential exists for errors to arise from causes such as misunderstood instructions, mistakes in judgment, and personal carelessness, distraction, or fatigue. Furthermore, policies and procedures whose effectiveness depends on segregation of duties can be circumvented by collusion. Similarly, irregularities perpetrated by management may not be susceptible to prevention or detection by specific control policies or procedures, because management may not be subject to the controls that deter employees or may override those controls.

.18 Custom, culture, and the corporate governance system may inhibit irregularities by management, but they are not infallible deterrents. An effective control environment, too, may help mitigate the probability of such irregularities. For example, control environment factors such as an effective board of directors, audit committee, and internal audit function may constrain improper conduct by management. Alternatively, an ineffective control environment may negate the effectiveness of control policies and procedures within the accounting system and other control procedures. For example, although an entity has good controls relating to the financial reporting process, a strong bias on the part of management to inflate reported earnings to maximize bonuses may result in financial statements that are materially misstated. The effectiveness of an entity's internal control structure might also be adversely affected by such factors as a change in ownership or control, changes in management or other personnel, or developments in the entity's market or industry.

Examination Engagement

.19 The practitioner's objective in an engagement to examine and report on management's assertion about the effectiveness of the entity's internal control structure is to express an opinion about whether management's assertion regarding the effectiveness of the entity's internal control structure is fairly stated, in all material respects, based upon the control criteria. The practitioner's opinion relates to the fair presentation of management's assertion about the effectiveness of the entity's internal control structure taken as a whole, and not to the effectiveness of each individual element (control environment, accounting system, and control procedures) of the entity's internal control structure.[7] Therefore, the practitioner considers the interrelationship of the elements of an entity's internal control structure in achieving the objectives of the control criteria. To express an opinion on management's assertion, the practitioner accumulates sufficient evidence about the design effectiveness and operating effectiveness of the entity's internal control structure to attest to management's assertion, thereby limiting attestation risk to an appropriately low level. When evaluating the design effectiveness of specific control policies and procedures, the practitioner considers whether the control policy or procedure is suitably designed to prevent or detect material misstatements on a timely basis. When evaluating operating effectiveness, the practitioner considers how the policy or procedure was applied, the consistency with which it was applied, and by whom it was applied.

.20 Performing an examination of management's assertion about the effectiveness of an entity's internal control structure involves (*a*) planning the engagement, (*b*) obtaining an understanding of the internal control structure, (*c*) testing and evaluating the design effectiveness of the internal control structure policies and procedures, (*d*) testing and evaluating the operating effectiveness of the internal control structure policies and procedures, and (*e*) forming an opinion about whether management's assertion regarding the effectiveness of the entity's internal control structure is fairly stated, in all material respects, based on the control criteria.

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[7] However, as discussed in paragraph .72, management's assertion may relate to a segment of its internal control structure.

Planning the Engagement

General Considerations

.21 Planning an engagement to examine and report on management's assertion about the effectiveness of the entity's internal control structure involves developing an overall strategy for the scope and performance of the engagement. When developing an overall strategy for the engagement, the practitioner should consider factors such as the following:

- Matters affecting the industry in which the entity operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes
- Knowledge of the entity's internal control structure obtained during other professional engagements
- Matters relating to the entity's business, including its organization, operating characteristics, capital structure, and distribution methods
- The extent of recent changes, if any, in the entity, its operations, or its internal control structure
- Management's method of evaluating the effectiveness of the entity's internal control structure based upon control criteria
- Preliminary judgments about materiality levels, inherent risk, and other factors relating to the determination of material weaknesses
- The type and extent of evidential matter supporting management's assertion about the effectiveness of the entity's internal control structure
- The nature of specific internal control structure policies and procedures designed to achieve the objectives of the control criteria, and their significance to the internal control structure taken as a whole
- Preliminary judgments about the effectiveness of the internal control structure

Multiple Locations

.22 A practitioner planning an engagement to examine management's assertion about the effectiveness of the internal control structure of an entity with operations in several locations should consider factors similar to those he or she would consider in performing an audit of the financial statements of an entity with multiple locations. It may not be necessary to understand and test controls at each location. In addition to the factors listed in paragraph .21, the selection of locations should be based on factors such as (*a*) the similarity of business operations and internal control structures at the various locations, (*b*) the degree of centralization of records, (*c*) the effectiveness of control environment policies and procedures, particularly those that affect management's direct control over the exercise of authority delegated to others and its ability to effectively supervise activities at the various locations, and (*d*) the nature and amount of transactions executed and related assets at the various locations.

Internal Audit Function

.23 Another factor the practitioner should consider when planning the engagement is whether the entity has an internal audit function. An important responsibility of the internal audit function is to monitor the performance of an entity's controls. One way internal auditors monitor such performance is by performing tests that provide evidence about the effectiveness of the design and operation of specific internal control structure policies and procedures. The results of these tests are often an important basis for management's assertions about the effectiveness of the entity's internal control structure. A practitioner should consider the guidance in AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, when assessing the competence and objectivity of internal auditors, the extent of work to be performed, and other matters.

Documentation

.24 Internal control structure policies and procedures and the control objectives that they were designed to achieve should be appropriately documented to serve as a basis for management's and the practitioner's reports. Such documentation is generally prepared by management. However, at management's request, the practitioner may assist in preparing or gathering such documentation. This documentation may take various forms: entity policy manuals, accounting manuals, narrative memoranda, flowcharts, decision tables, procedural write-ups, or completed questionnaires. No one particular form of documentation is necessary, and the extent of documentation may vary depending upon the size and complexity of the entity.

Obtaining an Understanding of the Internal Control Structure

.25 A practitioner generally obtains an understanding of the design of specific policies and procedures by making inquiries of appropriate management, supervisory, and staff personnel; by inspecting entity documents; and by observing entity activities and operations. The nature and extent of the procedures a practitioner performs vary from entity to entity and are influenced by factors such as those discussed in paragraphs .12 through .16.

Evaluating the Design Effectiveness of Internal Control Structure Policies and Procedures

.26 As discussed in paragraph .12, the elements that constitute an entity's internal control structure are a function of the definition of an internal control structure selected by management. Paragraph .27 describes the elements of the internal control structure that the practitioner should understand if management decides to evaluate and report on the entity's internal control structure based on the definition of an internal control structure contained in AU section 319. If management selects another definition of an internal control structure, the description of the elements contained in paragraph .27 may not be relevant.

.27 To evaluate the design of an entity's internal control structure, the practitioner should obtain an understanding of the internal control structure policies and procedures within each element (control environment, accounting system, and control procedures) of the internal control structure. These elements are described below:

a. An entity's control environment includes—
- Management's philosophy and operating style.
- The entity's organizational structure.
- The functioning of the board of directors and its committees, particularly the audit committee.
- Methods of assigning authority and responsibility.

- Management's control methods for monitoring and following up on performance, including internal auditing.
- Personnel policies and practices.
- Various external influences that affect an entity's operations, such as examinations by regulatory agencies.

b. An entity's accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. An effective accounting system gives appropriate consideration to establishing methods and records that will—

- Identify and record all valid transactions.
- Describe the transactions on a timely basis and in sufficient detail to permit proper classification for financial reporting.
- Measure the value of transactions in a manner that permits reporting of their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

c. An entity's control procedures may be categorized as procedures that pertain to—

- Proper authorization of transactions and activities.
- Segregation of duties to reduce the opportunity of any person to both perpetrate and conceal errors or irregularities in the normal course of his or her duties. It includes assigning to different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets.
- Design and use of adequate documents and records, and appropriate monitoring, to help ensure the proper recording of transactions and events, such as the monitoring of prenumbered shipping documents.
- Adequate safeguards over access to and use of assets and records, such as secured facilities and authorized access to computer programs and data files.
- Independent checks on performance and proper valuation of recorded amounts. These include clerical checks, reconciliations, comparison of assets with recorded accountability, computer-programmed controls, management review of reports that summarize the details of account balances (for example, an aged trial balance of accounts receivable), and user review of computer-generated reports.

In the context of an entity's internal control structure, safeguarding of assets refers only to protection against loss from errors and irregularities in the processing of transactions and the handling of related assets. It does not include, for example, loss of assets arising from management's operating decisions, such as selling a product that proves to be unprofitable, incurring expenditures for equipment or material that proves to be unnecessary or unsatisfactory, authorizing what proves to be unproductive research or ineffective advertising, or accepting some level of merchandise pilferage by customers as part of operating a retail business.

.28 Any of the elements of the internal control structure may include policies and procedures designed to achieve the objectives of the control criteria. Some control structure policies and procedures may have a pervasive effect on achieving many overall objectives of these criteria. For example, computer general controls over program development, program changes, computer operations, and access to programs and data help assure that specific controls over the processing of transactions are operating effectively. In contrast, other control structure policies and procedures are designed to achieve specific objectives of the control criteria. For example, management generally establishes specific control policies and procedures, such as accounting for all shipping documents, to ensure that all valid sales are recorded.

.29 The practitioner should focus on the significance of internal control structure policies and procedures in achieving the objectives of the control criteria rather than on specific policies and procedures in isolation. The absence or inadequacy of a specific policy or procedure designed to achieve the objectives of a specific criterion may not be a deficiency if other policies or procedures specifically address the same criterion. Further, when one or more internal control structure policy or procedure achieves the objectives of a specific criterion, the practitioner may not need to consider other policies or procedures designed to achieve those same objectives.

.30 Procedures to evaluate the effectiveness of the design of a specific internal control structure policy or procedure are concerned with whether that policy or procedure is suitably designed to prevent or detect material misstatements in specific financial statement assertions. Such procedures will vary depending upon the nature of the specific policy or procedure, the nature of the entity's documentation of the specific policy or procedure, and the complexity and sophistication of the entity's operations and systems.

Testing and Evaluating the Operating Effectiveness of Internal Control Structure Policies and Procedures

.31 To evaluate the operating effectiveness of an entity's internal control structure, the practitioner performs tests of relevant control structure policies and procedures to obtain sufficient evidence to support the opinion in the report. Tests of the operating effectiveness of an internal control structure policy or procedure are concerned with how the policy or procedure was applied, the consistency with which it was applied, and by whom it was applied. The tests ordinarily include procedures such as inquiries of appropriate personnel, inspection of relevant documentation, observation of the entity's operations, and reapplication or reperformance of the internal control structure procedure.

.32 The evidential matter that is sufficient to support a practitioner's opinion on management's assertion is a matter of professional judgment. However, the practitioner should consider matters such as the following:

- The nature of the internal control structure policy or procedure
- The significance of the internal control structure policy or procedure in achieving the objectives of the control criteria
- The nature and extent of tests of the operating effectiveness of internal control structure policies and procedures performed by the entity, if any

- The risk of noncompliance with the internal control structure policy or procedure, which might be assessed by considering the following:
  - Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness
  - Whether there have been changes in controls
  - The degree to which the control relies on the effectiveness of other controls (for example, control environment policies and procedures or computer general controls)
  - Whether there have been changes in key personnel who perform the control or monitor its performance
  - Whether the control relies on performance by an individual or by electronic equipment
  - The complexity of the control policy or procedure
  - Whether more than one control achieves a specific objective

.33 Management or other entity personnel may provide the practitioner with the results of their tests of the operating effectiveness of certain internal control structure policies and procedures. Although the practitioner should consider the results of such tests when evaluating the operating effectiveness of control structure policies and procedures, it is the practitioner's responsibility to obtain sufficient evidence to support his or her opinion and, if applicable, corroborate the results of such tests. When evaluating whether sufficient evidence has been obtained, the practitioner should consider that evidence obtained through his or her direct personal knowledge, observation, reperformance, and inspection is more persuasive than information obtained indirectly, such as from management or other entity personnel. Further, judgments about the sufficiency of evidence obtained and other factors affecting the practitioner's opinion, such as the materiality of identified control deficiencies, should be those of the practitioner.

.34 The nature of the policies and procedures influences the nature of the tests of controls the practitioner can perform. For example, the practitioner may examine documents regarding control structure policies and procedures for which documentary evidence exists. However, documentary evidence regarding some control environment policies and procedures (such as management's philosophy and operating style) often does not exist. In these circumstances, the practitioner's tests of controls would consist of inquiries of appropriate personnel and observation of entity activities. The practitioner's preliminary judgments about the effectiveness of control environment policies and procedures often influence the nature, timing, and extent of the tests of controls to be performed to obtain evidence about the operating effectiveness of control structure policies and procedures in the accounting system and other control procedures.

.35 The period of time over which the practitioner should perform tests of controls is a matter of judgment; however, it varies with the nature of the control policies and procedures being tested and with the frequency with which specific control procedures operate and specific policies are applied. Some control structure policies and procedures operate continuously (for example, controls over sales) while others operate only at certain times (for example, controls over the preparation of interim financial statements and controls over physical inventory counts). The practitioner should perform tests of controls over a period of time that is adequate to determine whether, as of the date selected by management for its assertion, the control structure policies and procedures necessary for achieving the objectives of the control criteria are operating effectively.

.36 Management may present a written assertion about the effectiveness of internal control structure policies and procedures related to the preparation of interim financial information. Depending on management's assertion, the practitioner should perform tests of internal control structure policies and procedures in effect during one or more interim periods to form an opinion about the effectiveness of such policies and procedures in achieving the related interim reporting objectives.

.37 Prior to the date as of which it presents its assertion, management may change the entity's internal control structure policies and procedures to make them more effective or efficient, or to address control deficiencies. In these circumstances, the practitioner may not need to consider control structure policies or procedures that have been superseded. For example, if the practitioner determines that the new control policies or procedures achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the practitioner to assess their design and operating effectiveness by performing tests of controls, the practitioner will not need to consider the design and operating effectiveness of the superseded control structure policies or procedures.

Forming an Opinion on Management's Assertion

.38 When forming an opinion on management's assertion about the effectiveness of an entity's internal control structure, the practitioner should consider all evidence obtained, including the results of the tests of controls and any identified control deficiencies, to evaluate the design and operating effectiveness of the internal control structure policies and procedures based on the control criteria.

Deficiencies in an Entity's Internal Control Structure

.39 During the course of the engagement, the practitioner may become aware of significant deficiencies in the entity's internal control structure. The practitioner's responsibility to communicate such deficiencies is described in paragraphs .45 and .46.

Reportable Conditions

.40 AU section 325, *Communication of Internal Control Structure Related Matters Noted in an Audit*, defines reportable conditions as matters coming to an auditor's attention that represent significant deficiencies in the design or operation of the internal control structure that could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Material Weaknesses

.41 A reportable condition may be of such magnitude as to be considered a material weakness. AU section 325 defines a material weakness as a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Therefore, the presence of a material weakness will preclude management from asserting that the entity has an effective internal control structure. However, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, management may qualify its assertion (that is, assert that the internal control structure is effective "except for" the material weakness noted).[8]

.42 When evaluating whether a reportable condition is also a material weakness, the practitioner should recognize that—

a. The amounts of errors or irregularities that might occur and remain undetected range from zero to more than the gross financial statement amounts or transactions that are exposed to the reportable condition.

b. The risk of errors or irregularities is likely to be different for the different possible amounts within that range. For example, the risk of errors or irregularities in amounts equal to the gross exposure might be very low, but the risk of smaller amounts might be progressively greater.

.43 In evaluating whether the combined effect of individual reportable conditions results in a material weakness, the practitioner should consider—

a. The range or distribution of the amounts of errors or irregularities that may result during the same accounting period from two or more individual reportable conditions.

b. The joint risk or probability that such a combination of errors or irregularities would be material.

.44 Evaluating whether a reportable condition is also a material weakness is a subjective process that depends on such factors as the nature of the accounting system and of any financial statement amounts or transactions exposed to the reportable condition, the overall control environment, other control procedures, and the judgment of those making the evaluation.

Communicating Reportable Conditions and Material Weaknesses

.45 A practitioner engaged to examine and report on management's assertion about the effectiveness of the entity's internal control structure should communicate reportable conditions to the audit committee[9] and identify the reportable conditions that are also considered to be material weaknesses. Such a communication should preferably be made in writing. Because of the potential for misinterpretation of the limited degree of assurance associated with the auditor issuing a written report representing that no reportable conditions were noted during the examination, the auditor should not issue such representations.

.46 Because timely communication may be important, the practitioner may choose to communicate significant matters during the course of the examination rather than after the examination is concluded. The decision about whether an interim communication should be issued would be influenced by the relative significance of the matters noted and the urgency of corrective follow-up action.

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[8] Paragraphs .56 through .62 contain guidance the practitioner should consider when reporting on a management assertion that contains, or should contain, a description of a material weakness.

[9] If the entity does not have an audit committee, the practitioner should communicate with individuals whose authority and responsibility are equivalent to those of an audit committee, such as the board of directors, the board of trustees, an owner in an owner-managed entity, or those who engaged the practitioner.

Management's Representations

.47 The practitioner should obtain written representations from management—[10]

a. Acknowledging management's responsibility for establishing and maintaining the internal control structure.

b. Stating that management has performed an evaluation of the effectiveness of the entity's internal control structure and specifying the control criteria used.

c. Stating management's assertion about the effectiveness of the entity's internal control structure based upon the control criteria.

d. Stating that management has disclosed to the practitioner all significant deficiencies in the design or operation of the internal control structure which could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements and has identified those that it believes to be material weaknesses in the internal control structure.

e. Describing any material irregularities and any other irregularities that, although not material, involve management or other employees who have a significant role in the entity's internal control structure.

f. Stating whether there were, subsequent to the date of management's report, any changes in the internal control structure or other factors that might significantly affect the internal control structure, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

.48 Management's refusal to furnish all appropriate written representations constitutes a limitation on the scope of the examination sufficient to require a qualified opinion or disclaimer of opinion on management's assertion about the effectiveness of the entity's internal control structure. Further, the practitioner should consider the effects of management's refusal on his or her ability to rely on other management representations.

Reporting Standards

.49 The form of the practitioner's report depends on the manner in which management presents its written assertion.

a. If management's assertion is presented in a separate report that accompanies the practitioner's report, the practitioner's report is considered appropriate for general distribution and the practitioner should use the form of report discussed in paragraphs .50 and .51.

b. If management presents its assertion only in a representation letter to the practitioner, the practitioner should restrict the distribution of his or her report to management, to others within the entity, and, if applicable, to specified regulatory agencies, and the practitioner should use the form of report discussed in paragraphs .52 through .54.

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[10] AU section 333, *Client Representations*, paragraph .09, provides guidance on the date as of which management should sign such a representation letter and which member(s) of management should sign it.

Management's Assertion Presented in a Separate Report

.50 When management presents its assertion in a separate report that will accompany the practitioner's report, the practitioner's report should include—

a. A title that includes the word *independent*.

b. An identification of management's assertion about the effectiveness of the entity's internal control structure over financial reporting.

c. A statement that the examination was made in accordance with standards established by the AICPA and, accordingly, that it included obtaining an understanding of the internal control structure over financial reporting, testing and evaluating the design and operating effectiveness of the internal control structure, and performing other such procedures as the practitioner considered necessary in the circumstances. In addition, the report should include a statement that the practitioner believes the examination provides a reasonable basis for his or her opinion.

d. A paragraph stating that, because of inherent limitations of any internal control structure, errors or irregularities may occur and not be detected. In addition, the paragraph should state that projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

e. The practitioner's opinion on whether management's assertion about the effectiveness of the entity's internal control structure over financial reporting as of the specified date is fairly stated, in all material respects, based on the control criteria.

.51 The following is the form of report a practitioner should use when he or she has examined management's assertion about the effectiveness of an entity's internal control structure as of a specified date.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] included in the accompanying [*title of management report*].[11]

[*Scope paragraph*]

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

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[11] The practitioner should identify the management report examined by referring to the title used by management in its report. Further, he or she should use the same description of the entity's internal control structure as management uses in its report, including the types of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting.

[Inherent limitations paragraph]

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[Opinion paragraph]

In our opinion, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify stated or established criteria*].[12]

Management's Assertion Presented Only in a Letter of Representation to the Practitioner

.52 Sometimes, management may present its written assertion about the effectiveness of the entity's internal control structure in a representation letter to the practitioner but not in a separate report that accompanies the practitioner's report. For example, an entity's board of directors may request the practitioner to report on management's assertion without requiring management to present a separate written assertion.

.53 When management does not present a written assertion that accompanies the practitioner's report, the practitioner should modify the report to include management's assertion about the effectiveness of the entity's internal control structure and add a paragraph that limits the distribution of the report to management, to others within the entity, and, if applicable, to a specified regulatory agency.

.54 A sample report that a practitioner might use in such circumstances follows.

Independent Accountant's Report

[Introductory paragraph]

We have examined management's assertion, included in its representation letter dated February 15, 19XY, that [*identify management's assertion, for example, W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*].

[Standard scope, inherent limitations, and opinion paragraphs]

[Limitation on distribution paragraph]

This report is intended solely for the information and use of the board of directors and management of W Company [*and, if applicable, a specified regulatory agency*] and should not be used for any other purpose.[13]

Report Modifications

.55 The practitioner should modify the standard reports in paragraphs .51 and .54 if any of the following conditions exist:

a. There is a material weakness in the entity's internal control structure (paragraphs .56 through .62).

b. There is a restriction on the scope of the engagement (paragraphs .63 through .66).

[12] For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

[13] If the report is a matter of public record, the following sentence should be added: "However, this report is a matter of public record and its distribution is not limited."

c. The practitioner decides to refer to the report of another practitioner as the basis, in part, for the practitioner's own report (paragraphs .67 and .68).

d. A significant subsequent event has occurred since the date of management's assertion (paragraphs .69 through .71).

e. Management presents an assertion about the effectiveness of only a segment of the entity's internal control structure (paragraph .72).

f. Management presents an assertion only about the suitability of design of the entity's internal control structure (paragraphs .73 and .74).

g. Management's assertion is based upon criteria established by a regulatory agency without following due process (paragraphs .75 through .79).

Material Weaknesses

.56 If the examination discloses conditions that, individually or in combination, result in one or more material weaknesses (paragraphs .41 through .44), the practitioner should modify the report. The nature of the modification depends on whether management includes, in its assertion, a description of the weakness and its effect on the achievement of the objectives of the control criteria.

Management Includes the Material Weakness in its Assertion

.57 If management includes in its assertion a description of the weakness and its effect on the achievement of the objectives of the control criteria, and if it appropriately modifies its assertion about the effectiveness of the entity's internal control structure in light of that weakness,[14] the practitioner should both modify the opinion paragraph by including a reference to the material weakness and add an explanatory paragraph (following the opinion paragraph) that describes the weakness.

.58 The following is the form of the report, modified with explanatory language, that a practitioner should use when management includes in its assertion a description of the weakness and its effect on the achievement of the objectives of the control criteria, and when it appropriately modifies its assertion about the effectiveness of the entity's internal control structure in light of that weakness.

Independent Accountant's Report

[*Standard introductory, scope, and inherent limitations paragraphs*]

[*Opinion paragraph*]

In our opinion, management's assertion that, except for the effect of the material weakness described in its report, [*identify management's assertion, for example, W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

[*Explanatory paragraph*]

As discussed in management's assertion, the following material weakness exists in the design or operation of the internal control structure of W Company in effect at [*date*]. [*Describe the material weakness and its effect*

[14] As stated in paragraph .41, the existence of a material weakness precludes management from asserting that an entity's internal control structure is effective.

on the achievement of the objectives of the control criteria.][15] A material weakness is a condition that precludes the entity's internal control structure from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis.[16]

Disagreements With Management

.59 In some circumstances, management may disagree with the practitioner over the existence of a material weakness and, therefore, not include in its assertion a description of such a weakness and its effect on the achievement of the objectives of the control criteria. In other circumstances, management may describe a material weakness but not modify its assertion that the entity's internal control structure is effective.[17] In such cases, the practitioner should express an adverse opinion on management's assertion.

.60 The following is the form of the report a practitioner should use when he or she concludes that an adverse opinion is appropriate in the circumstances.

Independent Accountant's Report

[*Standard introductory, scope and inherent limitations paragraphs*]

[*Explanatory paragraph*]

Our examination disclosed the following condition, which we believe is a material weakness in the design or operation of the internal control structure of W Company in effect at [*date*]. [*Describe the material weakness and its effect on achievement of the objectives of the control criteria.*] A material weakness is a condition that precludes the entity's internal control structure from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis.

[*Opinion paragraph*]

In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is not fairly stated based upon [*identify established or stated criteria*].

.61 If management's assertion contains a statement that management believes the cost of correcting the weakness would exceed the benefits to be derived from implementing new policies and procedures, the practitioner should disclaim an opinion on management's cost-benefit statement. The practitioner may use the following sample language as the last paragraph of the report to disclaim an opinion on management's cost-benefit statement:

We do not express an opinion or any other form of assurance on management's cost-benefit statement.

However, if the practitioner believes that management's cost-benefit statement is a material misstatement of fact, he or she should consider the guidance in paragraphs .82 and .83 and take appropriate action.

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[15] The language used by the practitioner ordinarily should conform with management's description of the effect of the material weakness on the effectiveness of the entity's internal control structure.

[16] This description of a material weakness differs from the definition of material weakness discussed in paragraph .41. Although a practitioner should consider the definition contained in paragraph .41 when determining whether a material weakness exists, the description above should be used to describe a material weakness in the practitioner's report.

[17] See footnote 15.

Management's Assertion Includes the Material Weakness and Is Presented in a Document Containing the Audit Report

.62 If the practitioner issues an examination report on management's assertion about the effectiveness of the entity's internal control structure within the same document that includes his or her audit report on the entity's financial statements, the following sentence should be included in the paragraph of the examination report that describes the material weakness:

> These conditions were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 19XX financial statements, and this report does not affect our report dated [*date of report*] on these financial statements.

The practitioner may also include the preceding sentence in situations where the two reports are not included within the same document.

Scope Limitations

.63 An unqualified opinion on management's assertion about the effectiveness of the entity's internal control structure can be expressed only if the practitioner has been able to apply all the procedures he or she considers necessary in the circumstances. Restrictions on the scope of the engagement, whether imposed by the client or by the circumstances, may require the practitioner to qualify or disclaim an opinion. The practitioner's decision to qualify or disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on management's assertion about the effectiveness of the entity's internal control structure.

.64 For example, management may have implemented control procedures to correct a material weakness identified prior to the date of its assertion. However, unless the practitioner has been able to obtain evidence that the new procedures were appropriately designed and have been operating effectively for a sufficient period of time,[18] he or she should refer to the material weakness described in the report and qualify his or her opinion on the basis of a scope limitation. The following is the form of the report a practitioner should use when restrictions on the scope of the examination cause the practitioner to issue a qualified opinion.

Independent Accountant's Report

[*Standard introductory paragraph*]

[*Scope paragraph*]

Except as described below, our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Standard inherent limitations paragraph*]

[*Explanatory paragraph*]

Our examination disclosed the following material weaknesses in the design or operation of the internal control structure of W Company in effect at [*date*]. A material weakness is a condition that precludes the entity's internal control structure from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis.

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[18] See guidance in paragraph .35.

Prior to December 20, 19XX, W Company had an inadequate system for recording cash receipts, which could have prevented the Company from recording cash receipts on accounts receivable completely and properly. Therefore, cash received could have been diverted for unauthorized use, lost, or otherwise not properly recorded to accounts receivable. Although the Company implemented a new cash receipts system on December 20, 19XX, the system has not been in operation for a sufficient period of time to enable us to obtain sufficient evidence about its operating effectiveness.

[*Opinion paragraph*]

In our opinion, except for the effect of matters we may have discovered had we been able to examine evidence about the effectiveness of the new cash receipts system, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

.65 When restrictions that significantly limit the scope of the examination are imposed by the client, the practitioner generally should disclaim an opinion on management's assertion about the effectiveness of the entity's internal control structure.

.66 The following is the form of report that a practitioner should use when restrictions that significantly limit the scope of the examination are imposed by the client and cause the practitioner to issue a disclaimer of opinion.

Independent Accountant's Report

[*Introductory paragraph*]

We were engaged to examine management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] included in the accompanying [*title of management's report*].

[*Scope paragraph should be omitted*]

[*Explanatory paragraph*]

[*Include paragraph to describe scope restrictions*]

[*Opinion paragraph*]

Since management [*describe scope restrictions*] and we were unable to apply other procedures to satisfy ourselves as to management's assertion about the entity's internal control structure over financial reporting, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on management's assertion.

Opinion Based in Part on the Report of Another Practitioner

.67 When another practitioner has examined management's assertion about the effectiveness of the internal control structure of one or more subsidiaries, divisions, branches, or components of the entity, the practitioner should consider whether he or she may serve as the principal practitioner and use the work and reports of the other practitioner as a basis, in part, for his or her opinion on management's assertion. If the practitioner decides it is appropriate for him or her to serve as the principal practitioner, he or she should then decide whether to make reference in the report to the examination performed by the other practitioner. In these circumstances, the practitioner's considerations are similar to those of the independent auditor who uses the work and reports of other independent auditors when reporting on an entity's financial statements. AU section 543, *Part of Audit Performed by Other Independent Auditors*, which provides guidance on the auditor's considerations when deciding whether he or she may serve as the principal auditor and, if so, whether to make reference to the examination performed by the other practitioner.

.68 When the practitioner decides to make reference to the report of the other practitioner as a basis, in part, for the practitioner's opinion on management's assertion, the practitioner should disclose this fact when describing the scope of the examination and should refer to the report of the other practitioner when expressing the opinion. The following form of the report is appropriate in these circumstances.

<u>Independent Accountant's Report</u>

[*Introductory paragraph*]

We have examined management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] included in the accompanying [*title of management report*]. We did not examine management's assertion about the effectiveness of the internal control structure over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 and 30 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 19XX. Management's assertion about the effectiveness of B Company's internal control structure over financial reporting was examined by other accountants whose report has been furnished to us, and our opinion, insofar as it relates to management's assertion about the effectiveness of B Company's internal control structure over financial reporting, is based solely on the report of the other accountants.

[*Scope paragraph*]

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination and the report of the other accountants provide a reasonable basis for our opinion.

[*Standard inherent limitations paragraph*]

[*Opinion paragraph*]

In our opinion, based on our examination and the report of the other accountants, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

Subsequent Events

.69 Changes in the internal control structure or other factors that might significantly affect the internal control structure may occur subsequent to the date of management's assertion but before the date of the practitioner's report. As described in paragraph .47, the practitioner should obtain management's representations relating to such matters. Additionally, to obtain information about whether changes have occurred that might affect management's assertion about the effectiveness of the entity's internal control structure and, therefore, the practitioner's report, he or she should inquire about and examine, for this subsequent period, the following:

a. Relevant internal auditor reports issued during the subsequent period *b.* Independent auditor reports (if other than the practitioner's) of reportable conditions or material weaknesses

c. Regulatory agency reports on the entity's internal control structure

d. Information about the effectiveness of the entity's internal control structure obtained through other professional engagements

.70 If the practitioner obtains knowledge about subsequent events that he or she believes significantly affect management's assertion about the effectiveness of the entity's internal control structure as of the date of management's assertion, the practitioner should ascertain that management has adequately described in its assertion these events and their effect on the internal control structure. If management has not included such a description and appropriately modified its assertion, the practitioner should add to his or her report an explanatory paragraph that includes such a description.

.71 The practitioner has no responsibility to keep informed of events subsequent to the date of his or her report; however, the practitioner may later become aware of conditions that existed at that date that might have affected the practitioner's opinion had he or she been aware of them. The practitioner's consideration of such subsequent information is similar to an auditor's consideration of information discovered subsequent to the date of the report on an audit of financial statements described in AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.* The guidance in that section requires the auditor to determine whether the information is reliable and whether the facts existed at the date of his or her report. If so, the auditor considers (*a*) whether the facts would have changed the report if he or she had been aware of them and (*b*) whether there are persons currently relying on or likely to rely on management's assertion about the effectiveness of the entity's internal control structure. Based on these considerations, detailed guidance is provided for the auditor in AU section 561.06.

Management's Assertion About the Effectiveness of a Segment of the Entity's Internal Control Structure

.72 When engaged to report on management's assertion about the effectiveness of only a segment of an entity's internal control structure (for example, the internal control structure over financial reporting of an entity's operating division or its accounts receivable), a practitioner should follow the guidance in this section and issue a report using the guidance in paragraphs .50 through .66, modified to refer to the segment of the entity's internal control structure examined. In this situation, the practitioner may use a report such as the following.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion [*identify management's assertion, for example, that W Company's retail division maintained an effective internal control structure over financial reporting as of December 31, 19XX*], included in the accompanying [*title of management report*].

[*Standard scope and inherent limitations paragraphs*]

[*Opinion paragraph*]

In our opinion, management's assertion [*identify management's assertion, for example, that W Company's retail division maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

Management's Assertion About the Suitability of Design of the Entity's Internal Control Structure

.73 Management may present an assertion about the suitability of the design of the entity's internal control structure for preventing or detecting material misstatements on a timely basis and request the practitioner to examine and report on the assertion. For example, prior to granting a new casino a license to operate, a regulatory agency may request a report on whether the internal control structure that management plans to implement will provide reasonable assurance that the control objectives specified in the regulatory agency's regulations will be achieved. When evaluating the suitability of design of the entity's internal control structure for the regulatory agency's purpose, the practitioner should obtain an understanding of the elements of the internal control structure[19] that management should implement to meet the control objectives of the regulatory agency and identify the internal control structure policies and procedures that are relevant to those control objectives.

.74 The following is a suggested form of report a practitioner may issue. The actual form of the report should be modified, as appropriate, to fit the particular circumstances.[20]

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion [*identify management's assertion, for example, that W Company's internal control structure over financial reporting is suitably designed to prevent or detect material misstatements in the financial statements on a timely basis as of December 31, 19XX*] included in the accompanying [*title of management report*].

[*Scope paragraph*]

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, evaluating the design of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Standard inherent limitations paragraph*]

[*Opinion paragraph*]

In our opinion, management's assertion [*identify management's assertion, for example, that W Company's internal control structure over financial reporting is suitably designed to prevent or detect material misstatements in the financial statements on a timely basis as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

When management presents such an assertion about an entity's internal control structure that has already been placed in operation, the practitioner should modify his or her report by adding the following to the scope paragraph of the report:

We were not engaged to examine and report on the operating effectiveness of W Company's internal control structure over financial reporting as of December 31, 19XX, and, accordingly, we express no opinion on operating effectiveness.

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[19] See paragraph .26.

[20] This report assumes that the control criteria of the regulatory agency have been subjected to due process and, therefore, are considered reasonable criteria for reporting purposes. Therefore, there is no limitation on the distribution of this report.

Management's Assertion Based on Criteria Specified by a Regulatory Agency

.75 A governmental or other agency that exercises regulatory, supervisory, or other public administrative functions may establish its own criteria and require reports on the internal control structures of entities subject to its jurisdiction. Criteria established by a regulatory agency may be set forth in audit guides, questionnaires, or other publications. The criteria may encompass specified aspects of an entity's internal control structure and specified aspects of administrative control or compliance with grants, regulations, or statutes. If such criteria have been subjected to due process procedures, including the broad distribution of proposed criteria for public comment, a practitioner should use the form of report illustrated in paragraph .51 or .54, depending on the manner in which management presents its assertion. If, however, such criteria have not been subjected to due process procedures, the practitioner should modify the report by adding a separate paragraph that limits the distribution of the report to the regulatory agency and to those within the entity.

.76 For purposes of these reports, a material weakness is—

a. A condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the applicable grant or program might occur and not be detected on a timely basis by employees in the normal course of performing their assigned functions.

b. A condition in which the lack of conformity with the regulatory agency's criteria is material in accordance with any guidelines for determining materiality that are included in such criteria.

.77 The following report illustrates one that a practitioner might use when he or she has examined management's assertion about the effectiveness of the entity's internal control structure based upon criteria established by a regulatory agency that did not follow due process.

<u>Independent Accountant's Report</u>

[*Introductory paragraph*]

We have examined management's assertion included in its representation letter dated February 15, 19XY, [*identify management's assertion, for example, that W Company's internal control structure over financial reporting as of December 31, 19XX is adequate to meet the criteria established by ______ agency, as set forth in its audit guide dated __________*].

[*Standard scope and inherent limitations paragraphs*]

[*Opinion paragraph*]

We understand that the agency considers internal control structure policies and procedures over financial reporting that meet the criteria referred to in the first paragraph of this report adequate for its purpose. In our opinion, based on this understanding and on our examination, management's assertion [*identify management's assertion, for example, that W Company's internal control structure over financial reporting is adequate to meet the criteria established by agency __________*] is fairly stated, in all material respects, based upon such criteria.

[*Limitation on distribution paragraph*]

This report is intended for the information and use of the board of directors and management of W Company and [*agency*] and should not be used for any other purpose.[21]

.78 When the practitioner issues this form of report, he or she does not assume any responsibility for the comprehensiveness of the criteria established by the regulatory agency. However, the practitioner should report any condition that comes to his or her attention during the course of the examination that he or she believes is a material weakness, even though it may not be covered by the criteria.

.79 If a regulatory agency requires management to report all conditions (whether material or not) that are not in conformity with the agency's criteria, the practitioner should determine whether all conditions of which he or she is aware have been reported by management. If the practitioner concludes that management has not reported all such conditions, he or she should describe them in the report.

Other Information in a Client-Prepared Document Containing Management's Assertion About the Effectiveness of the Entity's Internal Control Structure

.80 An entity may publish various documents that contain other information in addition to management's assertion on the effectiveness of the entity's internal control structure and the practitioner's report thereon. The practitioner may have performed procedures and issued a report covering some or all of this other information (for example, an audit report on the entity's financial statements), or another practitioner may have done so. Otherwise, the practitioner's responsibility with respect to other information in such a document does not extend beyond the management report identified in his or her report, and the practitioner has no obligation to perform any procedures to corroborate any other information contained in the document. However, the practitioner should read the other information not covered by the practitioner's report or by the report of the other practitioner and consider whether it, or the manner of its presentation, is materially inconsistent with the information appearing in management's report, or whether such information contains a material misstatement of fact.

.81 If the practitioner believes that the other information is inconsistent with the information appearing in management's report, he or she should consider whether management's report, the practitioner's report, or both require revision. If the practitioner concludes that these do not require revision, he or she should request management to revise the other information. If the other information is not revised to eliminate the material inconsistency, the practitioner should consider other actions, such as revising his or her report to include an explanatory paragraph describing the material inconsistency, withholding the use of his or her report in the document, or withdrawing from the engagement.

.82 If the practitioner discovers in the other information a statement that he or she believes is a material misstatement of fact, he or she should discuss the matter with management. In connection with this discussion, the practitioner should consider whether he or she possesses the expertise to assess the validity of the statement, whether standards exist by which to assess the

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[21] If the report is a matter of public record, the following sentence should be added: "However, this report is a matter of public record and its distribution is not limited."

manner of presentation of the information, and whether there may not be valid differences of judgment or opinion. If the practitioner concludes that a material misstatement exists, the practitioner should propose that management consult with some other party whose advice might be useful, such as the entity's legal counsel.

.83 If, after discussing the matter, the practitioner concludes that a material misstatement of fact remains, the action taken will depend on his or her judgment in the circumstances. The practitioner should consider steps such as notifying the entity's management and audit committee in writing of his or her views concerning the information and consulting his or her legal counsel about further action appropriate in the circumstances.

Relationship of the Practitioner's Examination of an Entity's Internal Control Structure to the Opinion Obtained in an Audit

.84 The purpose of a practitioner's examination of management's assertion about the effectiveness of an entity's internal control structure is to express an opinion about whether management's assertion that the entity maintained an effective internal control structure as of a point in time is fairly stated in all material respects, based on the control criteria. In contrast, the purpose of an auditor's consideration of the internal control structure in an audit of financial statements conducted in accordance with generally accepted auditing standards is to enable the auditor to plan the audit and determine the nature, timing, and extent of tests to be performed. Ultimately, the results of the auditor's tests will form the basis for the auditor's opinion on the fairness of the entity's financial statements in conformity with generally accepted accounting principles. The auditor's responsibility in considering the entity's internal control structure is discussed in AU section 319.

.85 In a financial statement audit, the auditor obtains an understanding of the internal control structure by performing procedures such as inquiries, observations, and inspection of documents. After he or she has obtained this understanding, the auditor assesses the control risk for assertions related to significant account balances and transaction classes. The auditor assesses control risk for an assertion at maximum if he or she believes that policies and procedures are unlikely to pertain to the assertion, that policies and procedures are unlikely to be effective, or that an evaluation of their effectiveness would be inefficient. When the auditor assesses control risk for an assertion at below maximum, he or she identifies the internal control structure policies and procedures that are likely to prevent or detect material misstatements in that assertion and performs tests of controls to evaluate the effectiveness of such policies and procedures.

.86 An auditor's consideration of the internal control structure in a financial statement audit is more limited than that of a practitioner engaged to examine management's assertion about the effectiveness of the entity's internal control structure. However, knowledge the practitioner obtains about the entity's internal control structure as part of the examination of management's assertion may serve as the basis for his or her understanding of the internal control structure in an audit of the entity's financial statements. Similarly, the practitioner may consider the results of tests of controls performed in connection with an examination of management's assertion, as well as any material weaknesses identified, when assessing control risk in the audit of the entity's financial statements.

.87 While an examination of management's assertions about the effectiveness of the entity's internal control structure and an audit of the entity's financial statements may be performed by the same practitioner, each can be performed by a different practitioner. If the audit of the entity's financial statements is performed by another practitioner, the practitioner may wish to consider any material weaknesses and reportable conditions identified by the auditor and any disagreements between management and the auditor concerning such matters.

Relationship to the Foreign Corrupt Practices Act

.88 The Foreign Corrupt Practices Act of 1977 (FCPA) includes provisions regarding internal accounting control for entities subject to the Securities Exchange Act of 1934. Whether an entity is in compliance with those provisions of the FCPA is a legal determination. A practitioner's examination report issued under this section does not indicate whether an entity is in compliance with those provisions.

Effective Date

.89 This section is effective for an examination of management's assertion on the effectiveness of an entity's internal control structure over financial reporting when the assertion is as of December 15, 1993 or thereafter. Earlier application of this section is encouraged.

.90 Appendix

The following documents contain guidance for practitioners engaged to provide other services in connection with an entity's internal control structure.

- AU section 325, *Communication of Internal Control Structure Related Matters Noted in an Audit*, provides guidance on identifying and communicating reportable conditions that come to the auditor's attention during an audit of financial statements.
- AU section 324, *Reports on the Processing of Transactions by Service Organizations*, provides guidance to auditors of a service organization on issuing a report on certain aspects of the service organization's internal control structure that can be used by other auditors, as well as guidance on how other auditors should use such reports.
- Statement of Position (SOP) 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance*, provides auditors of state and local governmental entities with a basic understanding of the work they should do and the reports they should issue for audits under *Government Auditing Standards* (1988 Revision), issued by the Comptroller General of the United States, the Single Audit Act of 1984, and Office of Management and Budget (OMB) Circular A-128, "Audits of State and Local Governments."
- SOP 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, provides auditors with a basic understanding of the work they should do and the reports they should issue for audits under *Government Auditing Standards* (1988 Revision), issued by the Comptroller General of the United States and OMB Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Organizations.*

[Revised March, 1995 by the Auditing Standards Division due to the issuance of Statement on Standards No. 74.] (See AU section 801.)

[The next page is 2781.]

AT Section 500

Compliance Attestation

Source: SSAE No. 3; SAS No. 74.

Effective for engagements in which management's assertion is as of, or for a period ending, June 15, 1994, or thereafter, unless otherwise indicated.

> *In January 1989, the Statements on Standards for Attestation Engagements (SSAE)* Attestation Standards *(AT section 100),* Financial Forecasts and Projections *(AT section 200), and* Reporting on Pro Forma Financial Information *(AT section 300), were codified in* Codification of Statements on Standards for Attestation Engagements. *In April 1993, the codified sections became SSAE No. 1,* Attestation Standards. *In May 1993, SSAE No. 2,* Reporting on an Entity's Internal Control Structure Over Financial Reporting, *was issued.*

Introduction and Applicability

.01 This section provides guidance for engagements related to management's written assertion about either (*a*) an entity's compliance with requirements of specified laws, regulations, rules, contracts, or grants or (*b*) the effectiveness of an entity's internal control structure over compliance with specified requirements.[1] Management's assertions may relate to compliance requirements that are either financial or nonfinancial in nature. An attestation engagement conducted in accordance with this section should comply with the general, fieldwork, and reporting standards in section 100, *Attestation Standards*, and the specific standards set forth in this section.

.02 This section does not—

a. Affect the auditor's responsibility in an audit of financial statements performed in accordance with generally accepted auditing standards (GAAS).

b. Apply to situations in which an auditor reports on specified compliance requirements based solely on an audit of financial statements, as addressed in AU section 623, *Special Reports*, paragraphs .19 through .21.

c. Apply to engagements for which the objective is to report in accordance with AU section 801, *Compliance Auditing Considerations in*

[1] Throughout this section—

a. An entity's compliance with requirements of specified laws, regulations, rules, contracts, or grants is referred to as compliance with specified requirements.

b. An entity's internal control structure over compliance with specified requirements is referred to as its internal control structure over compliance. The internal control structure addressed in this section may include parts of, but is not the same as, an internal control structure over financial reporting.

Audits of Governmental Entities and Recipients of Governmental Financial Assistance, unless the terms of the engagement specify an attestation report under this section.

d. Apply to engagements covered by AU section 634, *Letters for Underwriters and Certain Other Requesting Parties.*

e. Apply to the report that encompasses the internal control structure over compliance for a broker or dealer in securities as required by rule 17a-5 of the Securities Exchange Act of 1934.[2]

[As amended, effective for audits of financial statements and of compliance with laws and regulations for fiscal periods ending after December 31, 1994, by Statement on Auditing Standards No. 74.] (See AU section 801.)

.03 A report issued in accordance with the provisions of this section does not provide a legal determination on an entity's compliance with specified requirements. However, such a report may be useful to legal counsel or others in making such determinations.

Scope of Services

.04 The practitioner may be engaged to perform agreed-upon procedures to assist users in evaluating management's written assertion about (*a*) the entity's compliance with specified requirements, (*b*) the effectiveness of the entity's internal control structure over compliance,[3] or (*c*) both. The practitioner also may be engaged to examine management's written assertion about the entity's compliance with specified requirements.

.05 An important consideration in determining the type of engagement to be performed is expectations by users of the practitioner's report. Since the users decide the procedures to be performed in an agreed-upon procedures engagement, it often will be in the best interests of the practitioner and users (including the client) to have an agreed-upon procedures engagement rather than an examination engagement. When deciding whether to accept an examination engagement, the practitioner should consider the risks discussed in paragraphs .30 through .34.

.06 A practitioner may be engaged to examine management's assertion about the effectiveness of the entity's internal control structure over compliance. However, in accordance with section 100, the practitioner cannot accept an engagement unless management uses reasonable criteria that have been established by a recognized body or are stated in the presentation of management's assertion.[4] If a practitioner determines that such criteria do exist for an

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[2] An example of this report is contained in AICPA Statement of Position 89-4, *Reports on the Internal Control Structure in Audits of Brokers and Dealers in Securities.*

[3] An entity's internal control structure over compliance is the process by which management obtains reasonable assurance of compliance with specified requirements. Although the comprehensive internal control structure may include a wide variety of objectives and related policies and procedures, only some of these may be relevant to an entity's compliance with specified requirements (see footnote 1*b*). The components of the internal control structure over compliance vary based on the nature of the compliance requirements. For example, an internal control structure over compliance with a capital requirement would generally include accounting procedures, whereas an internal control structure over compliance with a requirement to practice nondiscriminatory hiring may not include accounting procedures.

[4] Criteria issued by regulatory agencies and other bodies composed of experts that follow due-process procedures, including procedures for broad distribution of proposed criteria for public comment, normally should be considered reasonable criteria for this purpose. For example, the

internal control structure over compliance, he or she should perform the engagement in accordance with section 100. Additionally, section 400, *Reporting on an Entity's Internal Control Structure Over Financial Reporting*, may be helpful to a practitioner in such an engagement.

.07 A practitioner should not accept an engagement to perform a review, as defined in section 100.40, of management's assertion about an entity's compliance with specified requirements or about the effectiveness of an entity's internal control structure over compliance.

.08 The guidance in this section does not apply unless management presents a written assertion. In the absence of a written assertion, management may engage the practitioner to provide certain nonattest services in connection with the entity's compliance with specified requirements or the entity's internal control structure over compliance. For example, management may engage the practitioner to provide recommendations on how to improve the entity's compliance or the related internal control structure. A practitioner engaged to provide such nonattest services should refer to the guidance in the Statement on Standards for Consulting Services, *Consulting Services: Definitions and Standards* [CS section 100].

Conditions for Engagement Performance

.09 A practitioner may perform an engagement related to management's written assertion about an entity's compliance with specified requirements or about the effectiveness of the internal control structure over compliance if both of the following conditions, along with the applicable conditions in paragraph .10 or .11, are met:

a. Management accepts responsibility for the entity's compliance with specified requirements and the effectiveness of the entity's internal control structure over compliance.

b. Management evaluates the entity's compliance with specified requirements or the effectiveness of the entity's internal control structure over compliance.

.10 A practitioner may perform agreed-upon procedures if, in addition to the conditions listed in paragraph .09, the following conditions are met:

a. Management makes an assertion about the entity's compliance with specified requirements or the effectiveness of the entity's internal control structure over compliance. The assertion should be in a representation letter to the practitioner and also may be in a separate report that will accompany the practitioner's report.

b. The agreed-upon procedures (1) are applied to the assertion (or its subject matter) that is capable of evaluation against reasonable criteria and (2) are expected to result in findings that are capable of reasonably consistent estimation or measurement.

(Footnote Continued)

Committee of Sponsoring Organizations (COSO) of the Treadway Commission's report, *Internal Control—Integrated Framework*, provides a general framework for effective internal control structures. However, more detailed criteria relative to specific compliance requirements may have to be developed and an appropriate threshold for measuring the severity of control deficiencies needs to be developed in order to apply the concepts of the COSO report to an internal control structure over compliance.

Criteria established by a regulatory agency that does not follow such due-process procedures also may be considered reasonable criteria for use by the regulatory agency. However, the practitioner's report generally would have to include a limitation of its use to those within the entity and the regulatory agency. (See section 100.14 through .16, .70, and .71.)

.11 A practitioner may perform an examination if, in addition to the conditions listed in paragraph .09, the following conditions are met:

a. Management makes an assertion about the entity's compliance with specified requirements. If the practitioner's report is intended for general use, the assertion should be in a representation letter to the practitioner and in a separate report that will accompany the practitioner's report.[5] If use of the practitioner's report will be restricted to those within the entity and a specified regulatory agency, the assertion might be only in a representation letter.

b. Management's assertion is capable of evaluation against reasonable criteria that either have been established by a recognized body or are stated in the assertion in a sufficiently clear and comprehensive manner for a knowledgeable reader to understand them, and the assertion is capable of reasonably consistent estimation or measurement using such criteria.[6]

c. Sufficient evidential matter exists or could be developed to support management's evaluation.

.12 In an agreed-upon procedures engagement, an assertion may be capable of reasonably consistent estimation or measurement using reasonable criteria, or an assertion may be one that is not measurable against reasonable criteria, possibly because the assertion is too broad or because such criteria do not exist. In these engagements, it is the assertion or its specific subject matter to which the agreed-upon procedures are to be applied that must satisfy the conditions set forth in the third general attestation standard. For example, an assertion may relate to compliance with an entire contractual agreement, but the practitioner may be engaged to perform agreed-upon procedures to only one aspect (that is, the subject matter) of the agreement. Since the procedures are agreed upon between the practitioner and the specified users, the criteria may be included within procedures that are expected to result in findings capable of reasonably consistent estimation or measurement.

.13 In an examination engagement, management's written assertion may take various forms but should be specific enough that users having competence in and using the same or similar measurement and disclosure criteria ordinarily would be able to arrive at materially similar conclusions. For example, an acceptable assertion about compliance with specified requirements might state, "Z Company complied with restrictive covenants contained in paragraphs 13, 14, 15, and 16a-d, of its Loan Agreement with Y Bank, dated January 1, 19X1, as of and for the three months ended June 30, 19X2." However, the practitioner should not examine an assertion that is too broad or subjective (for example, "X Company complied with laws and regulations applicable to its activities" or "X Company sufficiently complied") to be capable of reasonably consistent estimation or measurement.

Responsibilities of Management

.14 Management is responsible for ensuring that the entity complies with the requirements applicable to its activities. That responsibility encompasses (*a*) identifying applicable compliance requirements, (*b*) establishing and maintaining internal control structure policies and procedures to provide reasonable assurance that the entity complies with those requirements, (*c*)

[5] Management's report may be in the form of an assertion addressed to a third party or in the form of a prescribed schedule or declaration submitted to a third party.

[6] See footnote 4.

evaluating and monitoring the entity's compliance, and (*d*) specifying reports that satisfy legal, regulatory, or contractual requirements. Management's evaluation may include documentation such as accounting or statistical data, entity policy manuals, accounting manuals, narrative memoranda, procedural write-ups, flowcharts, completed questionnaires, or internal auditors' reports. The form and extent of documentation will vary depending on the nature of the compliance requirements and the size and complexity of the entity. Management may engage the practitioner to gather information to assist it in evaluating the entity's compliance. Regardless of the procedures performed by the practitioner, management must accept responsibility for its assertion and must not base such assertion solely on the practitioner's procedures.

Agreed-Upon Procedures Engagement

.15 The objective of the practitioner's agreed-upon procedures is to present specific findings to assist users in evaluating management's assertion about an entity's compliance with specified requirements or about the effectiveness of an entity's internal control structure over compliance based on procedures agreed upon by the users of the report.

.16 The practitioner's procedures generally may be as limited or extensive as the specified users desire as long as the specified users (*a*) participate in establishing the procedures to be performed and (*b*) take responsibility for the adequacy of such procedures for their purposes.[7] To satisfy these requirements, the practitioner ordinarily should ascertain whether the users have a clear understanding of the procedures to be performed by discussing the nature of management's assertion and the procedures with the users.

.17 If the practitioner is not able to discuss the procedures directly with all the specified users who will receive the report, he or she may satisfy the requirement that the specified users participate in establishing agreed-upon procedures and take responsibility for their sufficiency by applying any one of the following or similar procedures:

a. Compare the procedures to be applied to written requirements of the specified users.

b. Discuss the procedures to be applied with legal counsel or other appropriate representatives of the users involved.

c. Review relevant contracts with or correspondence from the specified users.

d. Distribute a draft of the anticipated report or a copy of a proposed engagement letter to the specified users with a request for their comments.

.18 In an engagement to apply agreed-upon procedures to management's assertion about an entity's compliance with specified requirements or about the effectiveness of an entity's internal control structure over compliance, the practitioner is required to perform only the procedures that have been agreed to by users.[8] However, prior to performing such procedures, the practitioner should—

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[7] However, in accordance with section 100.44, a mere reading of management's assertion does not constitute a procedure sufficient to permit a practitioner to report on the results of applying agreed-upon procedures.

[8] AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, was not written to apply to agreed-upon procedures engagements. The Auditing Standards Board is addressing internal auditors' participation in agreed-upon procedures engagements as part of a separate project on the overall concept of such engagements. The board has, however, concluded that a practitioner may not use internal auditors for direct assistance in an agreed-upon procedures engagement to satisfy the requirement in the Federal Deposit Insur-

a. Obtain an understanding of the specified compliance requirements, as discussed in paragraph .19.

b. Plan the engagement, as discussed in the applicable portions of section 100.28 through .32.

.19 To obtain an understanding of the requirements specified in management's assertion about compliance, a practitioner should consider the following:

a. Laws, regulations, rules, contracts, and grants that pertain to the specified compliance requirements, including published requirements

b. Knowledge about the specified compliance requirements obtained through prior engagements and regulatory reports

c. Knowledge about the specified compliance requirements obtained through discussions with appropriate individuals within the entity (for example, the chief financial officer, internal auditors, legal counsel, compliance officer, or grant or contract administrators)

d. Knowledge about the specified compliance requirements obtained through discussions with appropriate individuals outside the entity (for example, a regulator or a third-party specialist)

.20 When circumstances impose restrictions on the scope of an agreed-upon procedures engagement, the practitioner should attempt to obtain agreement from the users for modification of the agreed-upon procedures. When such agreement cannot be obtained (for example, when the agreed-upon procedures are published by a regulatory agency that will not modify the procedures), the practitioner should describe such restrictions in his or her report or withdraw from the engagement.

.21 The practitioner has no obligation to perform procedures beyond the agreed-upon procedures. However, if noncompliance related to management's assertion comes to the practitioner's attention by other means, such information ordinarily should be included in his or her report.

.22 The practitioner may become aware of noncompliance related to management's assertion that occurs subsequent to the period addressed by management's assertion but before the date of the practitioner's report. The practitioner should consider including information regarding such noncompliance in his or her report. However, the practitioner has no responsibility to perform procedures to detect such noncompliance other than obtaining management's representation about noncompliance in the subsequent period, as described in paragraph .70.

.23 The practitioner's report on agreed-upon procedures related to management's assertion about an entity's compliance with specified requirements or about the effectiveness of an entity's internal control structure over compliance should be in the form of procedures and findings. The practitioner should not provide negative assurance about whether management's assertion is fairly stated. The practitioner's report, which ordinarily is addressed to the entity, should contain—

a. A title that includes the word *independent.*

(Footnote Continued)

ance Corporation Improvement Act of 1991 that an independent accountant perform agreed-upon procedures to test a financial institution's compliance with designated laws and regulations relating to safety and soundness.

b. A statement that the procedures, which were agreed to by the specified users of the report, were performed to assist the users in evaluating management's assertion about the entity's compliance with specified requirements or about the effectiveness of its internal control structure over compliance.

c. A reference to management's assertion about the entity's compliance with specified requirements, or about the effectiveness of an entity's internal control structure over compliance, including the period or point in time addressed in management's assertion.[9]

d. A statement that the sufficiency of the procedures is solely the responsibility of the parties specifying the procedures and a disclaimer of responsibility for the sufficiency of those procedures.

e. A list of the procedures performed (or reference thereto) and related findings.[10]

f. A statement that the work performed was less in scope than an examination of management's assertion about compliance with specified requirements or about the effectiveness of an entity's internal control structure over compliance, a disclaimer of opinion, and a statement that if additional procedures had been performed, other matters might have come to the practitioner's attention that would have been reported.

g. A statement of limitations on the use of the report because it is intended solely for the use of specified parties.

.24 The following is an illustration of an agreed-upon procedures report on management's assertion about an entity's compliance with specified requirements in which the procedures and findings are enumerated rather than referenced.

Independent Accountant's Report

We have performed the procedures enumerated below, which were agreed to by [*list users of report*], solely to assist the users in evaluating management's assertion about [*name of entity*]'s compliance with [*list specified requirements*] during the [*period*] ended [*date*], included in the accompanying [*title of management report*].[11, 12] The sufficiency of these procedures is solely the responsibility of the specified users of the report. Consequently, we make no representation regarding the sufficiency of the procedures described below

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[9] Generally, management's assertion about compliance with specified requirements will address a period whereas an assertion about an internal control structure over compliance will address a point in time.

[10] The presentation of procedures performed should be on a level of specificity sufficient for the reader to understand the nature and extent of the procedures performed. For example, a practitioner's report might state, ". . . we agreed the amounts in each quarterly financial status report to the general ledger . . ." rather than ". . . we verified the quarterly financial status reports. . . ." Also, for example, a practitioner's report might state, ". . . we traced approval of 100 loans to . . ." rather than ". . . we traced approval of a sample of loans to. . . ." Terms of uncertain meaning (such as general review, limited review, reconcile, check, or test) should not be used in describing the work unless the procedures comprehended by these terms are described in the practitioner's report.

[11] If management's assertion is in a representation letter rather than a separate, attached report, the first sentence of this paragraph would state: "We have performed the procedures enumerated below, . . ., included in its representation letter dated [*date*]."

[12] If the agreed-upon procedures have been published by a third-party user (for example, a regulator in regulatory policies or a lender in a debt agreement), this sentence might begin: "We have performed the procedures included in [*title of publication or other document*], which were agreed to by [*list users of report*], solely to assist the users in evaluating management's assertion about . . . ."

either for the purpose for which this report has been requested or for any other purpose.

[*Include paragraphs to enumerate procedures and findings.*]

These agreed-upon procedures are substantially less in scope than an examination, the objective of which is the expression of an opinion on [*title of management report*]. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information of the audit committee, management, and the parties listed in the first paragraph, and should not be used by those who did not participate in determining the procedures.[13]

.25 Evaluating compliance with certain requirements may require interpretation of the laws, regulations, rules, contracts, or grants that establish those requirements. In such situations, the practitioner should consider whether he or she is provided with the reasonable criteria required to evaluate an assertion under the third general attestation standard. If these interpretations are significant, the practitioner may include a paragraph stating the description and the source of interpretations made by the entity's management. An example of such a paragraph, which should precede the procedures and findings paragraph(s), follows:

We have been informed that, under [*name of entity*]'s interpretation of [*identify the compliance requirement*], [*explain the nature and source of the relevant interpretation*].

.26 The following is an illustration of an agreed-upon procedures report on management's assertion about the effectiveness of an entity's internal control structure over compliance in which the procedures and findings are enumerated rather than referenced.

<u>Independent Accountant's Report</u>

We have performed the procedures enumerated below, which were agreed to by [*list users of report*], solely to assist the users in evaluating management's assertion about the effectiveness of [*name of entity*]'s internal control structure over compliance with [*list specified requirements*] as of [*date*], included in the accompanying [*title of management report*].[14] The sufficiency of these procedures is solely the responsibility of the specified users of the report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

[*Include paragraphs to enumerate procedures and findings.*]

These agreed-upon procedures are substantially less in scope than an examination, the objective of which is the expression of an opinion on [*title of management report*]. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information of the audit committee, management, and the parties listed in the first paragraph, and should not be used by those who did not participate in determining the procedures.[15]

.27 In some agreed-upon procedures engagements, management's assertion may address both compliance with specified requirements and the effectiveness of the internal control structure over compliance. In these engagements, the practitioner may issue one report that addresses both asser-

[13] If the report is part of the public record, the following sentence should be included in the report: "However, this report is a matter of public record and its distribution is not limited."

[14] See footnotes 11 and 12.

[15] See footnote 13.

tions. For example, the first sentence of the introductory paragraph would state—

> We have performed the procedures enumerated below, which were agreed to by [*list users of report*], solely to assist the users in evaluating management's assertions about [*name of entity*]'s compliance with [*list specified requirements*] during the [*period*] ended [*date*] and about the effectiveness of [*name of entity*]'s internal control structure over compliance with the aforementioned compliance requirements as of [*date*], included in the accompanying [*title of management report*].

.28 The date of completion of the agreed-upon procedures should be used as the date of the practitioner's report.

Examination Engagement

.29 The objective of the practitioner's examination procedures applied to management's assertion about an entity's compliance with specified requirements is to express an opinion about whether management's assertion is fairly stated in all material respects based on established or agreed-upon criteria. To express such an opinion, the practitioner accumulates sufficient evidence in support of management's assertion about the entity's compliance with specified requirements, thereby limiting attestation risk to an appropriately low level.

Attestation Risk

.30 In an engagement to examine management's assertion about compliance with specified requirements, the practitioner seeks to obtain reasonable assurance that management's assertion is fairly stated in all material respects based on established or agreed-upon criteria. This includes designing the examination to detect both intentional and unintentional noncompliance that is material to management's assertion. Absolute assurance is not attainable because of factors such as the need for judgment, the use of sampling, and the inherent limitations of the internal control structure over compliance and because much of the evidence available to the practitioner is persuasive rather than conclusive in nature. Also, procedures that are effective for detecting noncompliance that is unintentional may be ineffective for detecting noncompliance that is intentional and is concealed through collusion between client personnel and third parties or among management or employees of the client. Therefore, the subsequent discovery that material noncompliance exists does not, in and of itself, evidence inadequate planning, performance, or judgment on the part of the practitioner.

.31 Attestation risk is the risk that the practitioner may unknowingly fail to modify appropriately his or her opinion on management's assertion. It is composed of inherent risk, control risk, and detection risk. For purposes of a compliance examination, these components are defined as follows:

a. Inherent risk—The risk that material noncompliance with specified requirements could occur, assuming there are no related internal control structure policies or procedures.

b. Control risk—The risk that material noncompliance that could occur will not be prevented or detected on a timely basis by the entity's internal control structure policies and procedures.

c. Detection risk—The risk that the practitioner's procedures will lead him or her to conclude that material noncompliance does not exist when, in fact, such noncompliance does exist.

Inherent Risk

.32 In assessing inherent risk, the practitioner should consider factors affecting risk similar to those an auditor would consider when planning an audit of financial statements. Such factors are discussed in AU section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* paragraphs .10 through .12. In addition, the practitioner should consider factors relevant to compliance engagements, such as the following:

- The complexity of the specified compliance requirements
- The length of time the entity has been subject to the specified compliance requirements
- Prior experience with the entity's compliance
- The potential impact of noncompliance

Control Risk

.33 The practitioner should assess control risk as discussed in paragraphs .44 and .45. Assessing control risk contributes to the practitioner's evaluation of the risk that material noncompliance exists. The process of assessing control risk (together with assessing inherent risk) provides evidential matter about the risk that such noncompliance may exist. The practitioner uses this evidential matter as part of the reasonable basis for his or her opinion on management's assertion.

Detection Risk

.34 In determining an acceptable level of detection risk, the practitioner assesses inherent risk and control risk and considers the extent to which he or she seeks to restrict attestation risk. As assessed inherent risk or control risk decreases, the acceptable level of detection risk increases. Accordingly, the practitioner may alter the nature, timing, and extent of compliance tests performed based on the assessments of inherent risk and control risk.

Materiality

.35 In an examination of management's assertion about an entity's compliance with specified requirements, the practitioner's consideration of materiality differs from that in an audit of financial statements in accordance with GAAS. In an examination of management's assertion about an entity's compliance with specified requirements, the practitioner's consideration of materiality is affected by (*a*) the nature of management's assertion and the compliance requirements, which may or may not be quantifiable in monetary terms, (*b*) the nature and frequency of noncompliance identified with appropriate consideration of sampling risk, and (*c*) qualitative considerations, including the needs and expectations of the report's users.

.36 In some situations, the terms of the engagement may provide for a supplemental report of all or certain noncompliance discovered. Such terms should not change the practitioner's judgments about materiality in planning and performing the engagement or in forming an opinion on management's assertion about an entity's compliance with specified requirements.

Performing an Examination Engagement

.37 The practitioner should exercise (*a*) due care in planning, performing, and evaluating the results of his or her examination procedures and (*b*) the proper degree of professional skepticism to achieve reasonable assurance that material noncompliance will be detected.

.38 In an examination of management's assertion about the entity's compliance with specified requirements, the practitioner should—

a. Obtain an understanding of the specified compliance requirements (paragraph .39).

b. Plan the engagement (paragraphs .40 through .43).

c. Consider relevant portions of the entity's internal control structure over compliance (paragraphs .44 through .46).

d. Obtain sufficient evidence including testing compliance with specified requirements (paragraphs .47 through .48).

e. Consider subsequent events (paragraphs .49 through .51).

f. Form an opinion about whether management's assertion about the entity's compliance with specified requirements is fairly stated in all material respects based on the established or agreed-upon criteria (paragraph .52).

Obtaining an Understanding of the Specified Compliance Requirements

.39 A practitioner should obtain an understanding of the requirements specified in management's assertion about compliance. To obtain such an understanding, a practitioner should consider the following:

a. Laws, regulations, rules, contracts, and grants that pertain to the specified compliance requirements, including published requirements

b. Knowledge about the specified compliance requirements obtained through prior engagements and regulatory reports

c. Knowledge about the specified compliance requirements obtained through discussions with appropriate individuals within the entity (for example, the chief financial officer, internal auditors, legal counsel, compliance officer, or grant or contract administrators)

d. Knowledge about the specified compliance requirements obtained through discussions with appropriate individuals outside the entity (for example, a regulator or a third-party specialist)

Planning the Engagement

General Considerations

.40 Planning an engagement to examine management's assertion about the entity's compliance with specified requirements involves developing an overall strategy for the expected conduct and scope of the engagement. The practitioner should consider the planning matters discussed in section 100.28 through .32.

Multiple Components

.41 In an engagement to examine management's assertion about an entity's compliance with specified requirements when the entity has operations in several components (for example, locations, branches, subsidiaries, or programs), the practitioner may determine that it is not necessary to test compliance with requirements at every component. In making such a determination and in selecting the components to be tested, the practitioner should consider factors such as the following: (*a*) the degree to which the specified compliance requirements apply at the component level, (*b*) judgments about materiality, (*c*) the degree of centralization of records, (*d*) the effectiveness of control environment policies and procedures, particularly those that affect management's direct control over the exercise of authority delegated to others and its ability to supervise activities at various locations effectively, (*e*) the nature and extent of operations conducted at the various components, and (*f*) the similarity of operations and internal control structure policies and procedures over compliance for different components.

Using the Work of a Specialist

.42 In some compliance engagements, the nature of the specified compliance requirements may require specialized skill or knowledge in a particular field other than accounting or auditing. In such cases, the practitioner may use the work of a specialist and should follow the relevant performance and reporting guidance in AU section 336, *Using the Work of a Specialist*.

Internal Audit Function

.43 Another factor the practitioner should consider when planning the engagement is whether the entity has an internal audit function and the extent to which internal auditors are involved in monitoring compliance with the specified requirements. A practitioner should consider the guidance in AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, when addressing the competence and objectivity of internal auditors, the nature, timing, and extent of work to be performed, and other related matters.

Consideration of the Internal Control Structure Over Compliance

.44 The practitioner should obtain an understanding of relevant portions of the internal control structure over compliance sufficient to plan the engagement and to assess control risk for compliance with specified requirements. In planning the examination, such knowledge should be used to identify types of potential noncompliance, to consider factors that affect the risk of material noncompliance, and to design appropriate tests of compliance.

.45 A practitioner generally obtains an understanding of the design of specific internal control structure policies and procedures by performing: inquiries of appropriate management, supervisory, and staff personnel; inspection of the entity's documents; and observation of the entity's activities and operations. The nature and extent of procedures a practitioner performs vary from entity to entity and are influenced by factors such as the newness and complexity of the specified requirements, the practitioner's knowledge of the internal control structure over compliance obtained in previous professional engagements, the nature of the specified compliance requirements, an understanding of the industry in which the entity operates, and judgments about materiality. When seeking to assess control risk below the maximum, the practitioner should perform tests of controls to obtain evidence to support the assessed level of control risk.

.46 During the course of an engagement to examine management's assertion, the practitioner may become aware of significant deficiencies in the design or operation of the internal control structure over compliance that could affect adversely the entity's ability to comply with specified requirements. A practitioner's responsibility to communicate these deficiencies in an examination of management's assertion about an entity's compliance with specified requirements is similar to the auditor's responsibility described in

AU section 325, *Communication of Internal Control Structure Related Matters Noted in an Audit.*

Obtaining Sufficient Evidence

.47 The practitioner should apply procedures to provide reasonable assurance of detecting material noncompliance. Determining these procedures and evaluating the sufficiency of the evidence obtained are matters of professional judgment. When exercising such judgment, practitioners should consider the guidance contained in section 100.36 through .39, and AU section 350, *Audit Sampling.*

.48 For engagements involving compliance with regulatory requirements, the practitioner's procedures should include reviewing reports of significant examinations and related communications between regulatory agencies and the entity and, when appropriate, making inquiries of the regulatory agencies, including inquiries about examinations in progress.

Consideration of Subsequent Events

.49 The practitioner's consideration of subsequent events in an examination of management's assertion about the entity's compliance with specified requirements is similar to the auditor's consideration of subsequent events in a financial statement audit, as outlined in AU section 560, *Subsequent Events.* The practitioner should consider information about such events that comes to his or her attention after the end of the period addressed by management's assertion and prior to the issuance of his or her report.

.50 Two types of subsequent events require consideration by management and evaluation by the practitioner. The first consists of events that provide additional information about the entity's compliance during the period addressed by management's assertion and may affect management's assertion and, therefore, the practitioner's report. For the period from the end of the reporting period (or point in time) to the date of the practitioner's report, the practitioner should perform procedures to identify such events that provide additional information about compliance during the reporting period. Such procedures should include, but may not be limited to, inquiring about and considering the following information:

- Relevant internal auditors' reports issued during the subsequent period
- Other practitioners' reports identifying noncompliance, issued during the subsequent period
- Regulatory agencies' reports on the entity's noncompliance, issued during the subsequent period
- Information about the entity's noncompliance, obtained through other professional engagements for that entity

.51 The second type consists of noncompliance that occurs subsequent to the period addressed by management's assertion but before the date of the practitioner's report. The practitioner has no responsibility to detect such noncompliance. However, should the practitioner become aware of such noncompliance, it may be of such a nature and significance that disclosure of it is required to keep management's assertion from being misleading. In such cases, the practitioner should include, in his or her report, an explanatory paragraph describing the nature of the noncompliance if it was not disclosed in management's assertion accompanying the practitioner's report.

Forming an Opinion on Management's Assertion

.52 In evaluating whether management's assertion is stated fairly in all material respects, the practitioner should consider (*a*) the nature and frequency of the noncompliance identified and (*b*) whether such noncompliance is material relative to the nature of the compliance requirements, as discussed in paragraph .35.

Reporting

.53 The form of the practitioner's report depends on, among other things, the method in which management presents its written assertion:

- If management's assertion is presented in a separate report that will accompany the practitioner's report, the practitioner should use the form of report discussed in paragraphs .54 and .55.
- If management presents its assertion only in a representation letter to the practitioner, the practitioner should use the form of report discussed in paragraphs .56 and .57.

.54 When management presents its assertion in a separate report that will accompany the practitioner's report, the practitioner's report, which is ordinarily addressed to the entity, should include—

a. A title that includes the word *independent*.

b. A reference to management's assertion about the entity's compliance with specified requirements, including the period covered by management's assertion.[16]

c. A statement that compliance with the requirements addressed in management's assertion is the responsibility of the entity's management and that the practitioner's responsibility is to express an opinion on management's assertion about compliance with those requirements based on the examination.

d. A statement that the examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about the entity's compliance with those requirements and performing such other procedures as the practitioner considered necessary in the circumstances. In addition, the report should include a statement that the practitioner believes the examination provides a reasonable basis for his or her opinion and a statement that the examination does not provide a legal determination on the entity's compliance.

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[16] A practitioner also may be engaged to report on management's assertion about an entity's compliance with specified requirements as of a point in time. In this case, the illustrative reports in this section should be adapted as appropriate.

e. The practitioner's opinion on whether management's assertion is fairly stated, in all material respects, based on established or agreed-upon criteria.[17, 18]

.55 The following is the form of report a practitioner should use when he or she has examined management's assertion about an entity's compliance with specified requirements during a period of time.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion about [*name of entity*]'s compliance with [*list specified compliance requirements*] during the [*period*] ended [*date*] included in the accompanying [*title of management report*].[19] Management is responsible for [*name of entity*]'s compliance with those requirements. Our responsibility is to express an opinion on management's assertion about the Company's compliance based on our examination.

[*Scope paragraph*]

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about [*name of entity*]'s compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. Our examination does not provide a legal determination on [*name of entity*]'s compliance with specified requirements.

[*Opinion paragraph*]

In our opinion, management's assertion [*identify management's assertion—for example, that Z Company complied with the aforementioned requirements for the year ended December 31, 19X1*] is fairly stated, in all material respects.[20]

.56 When management presents its written assertion about an entity's compliance in a representation letter to the practitioner and not in a separate report to accompany the practitioner's report, the practitioner should modify his or her report to include management's assertion about the entity's compliance and add a paragraph that limits the use of the report to specified parties. For example, a regulatory agency may request a report from the practitioner on management's assertion about the entity's compliance with specified requirements but not request a separate written assertion from management.

.57 The following is the form of report that a practitioner should use in such circumstances.

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[17] Frequently, criteria will be contained in the compliance requirements, in which case it is not necessary to repeat the criteria in the practitioner's report; however, if the criteria are not included in the compliance requirement, the practitioner's report should identify the criteria. For example, if a compliance requirement is to "maintain $25,000 in capital," it would not be necessary to identify the $25,000 in the report; however, if the requirement is to "maintain adequate capital," the practitioner should identify the criteria used to define "adequate."

[18] Although the practitioner's report generally will be for general use when management presents its assertion in an accompanying report, the practitioner is not precluded from restricting the use of the report.

[19] The practitioner should identify the management report examined by reference to the report title used by management in its report. Further, he or she should use the same description of the compliance requirements as management uses in its report.

[20] If it is necessary to identify criteria (see footnote 17), the criteria should be identified in the opinion paragraph (for example, ". . . in all material respects, based on the criteria set forth in Attachment 1").

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion, included in its representation letter dated [*date*], that [*name of entity*] complied with [*list specified compliance requirements*] during the [*period*] ended [*date*]. As discussed in that representation letter, management is responsible for [*name of entity*]'s compliance with those requirements. Our responsibility is to express an opinion on management's assertion about the Company's compliance based on our examination.

[*Standard scope and opinion paragraphs*]

[*Limitation on use paragraph*]

This report is intended solely for the information of the audit committee, management, and [*specify legislative or regulatory body*].[21]

.58 When the presentation of assertions has been prepared in conformity with specified criteria that have been agreed upon by management and the users, the practitioner's report also should contain a statement of limitations on the use of the report because it is intended solely for specified parties.[22]

.59 Evaluating compliance with certain requirements may require interpretation of the laws, regulations, rules, contracts, or grants that establish those requirements. In such situations, the practitioner should consider whether he or she is provided with the reasonable criteria required to evaluate an assertion under the third general attestation standard. If these interpretations are significant, the practitioner may include a paragraph stating the description and the source of interpretations made by the entity's management. The following is an example of such a paragraph, which should directly follow the scope paragraph:

We have been informed that, under [*name of entity*]'s interpretation of [*identify the compliance requirement*], [*explain the source and nature of the relevant interpretation*].

.60 The date of completion of the examination procedures should be used as the date of the practitioner's report.

Report Modifications

.61 The practitioner should modify the standard reports in paragraphs .55 and .57, if any of the following conditions exist:

- There is material noncompliance with specified requirements (paragraphs .62 through .68).
- There is a matter involving a material uncertainty (paragraph .69).
- There is a restriction on the scope of the engagement.[23]
- The practitioner decides to refer to the report of another practitioner as the basis, in part, for the practitioner's report.[24]

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[21] If the report is part of the public record, the following sentence should be included in the report: "However, this report is a matter of public record and its distribution is not limited."

[22] In certain situations, however, criteria that have been specified by management and other report users may be "reasonable" for general distribution. See section 100.70.

[23] The practitioner should refer to section 400.63 through .66 for guidance on a report modified for a scope restriction and adapt such guidance to the standard reports in this section.

[24] The practitioner should refer to section 400.67 through .68 for guidance on an opinion based in part on the report of another practitioner and adapt such guidance to the standard reports in this section.

Material Noncompliance

.62 When an examination of management's assertion about an entity's compliance with specified requirements discloses noncompliance with the applicable requirements that the practitioner believes have a material effect on the entity's compliance, the practitioner should modify the report. The nature of the report modification depends on whether management discloses, in its assertion, a description of the noncompliance with requirements.

.63 If management discloses the noncompliance and appropriately modifies its assertion about the entity's compliance with specified requirements, the practitioner should modify the opinion paragraph by including a reference to the noncompliance and add an explanatory paragraph (after the opinion paragraph) that emphasizes the noncompliance.

.64 The following is the form of report, modified with explanatory language, that a practitioner should use when he or she has identified noncompliance and management has appropriately modified its assertion for the noncompliance.

<u>Independent Accountant's Report</u>

[*Standard introductory and scope paragraphs*]

[*Opinion paragraph*]

In our opinion, management's assertion [*identify management's assertion, for example, that except for noncompliance with (list requirements) Z Company complied with the aforementioned requirements for the year ended December 31, 19X1*], described in management's report, is fairly stated, in all material respects.

[*Explanatory paragraph*]

As discussed in management's assertion, the following material noncompliance occurred at [*name of entity*] during the [*period*] ended [*date*]. [*Describe noncompliance.*]

.65 In some circumstances, management may disagree with the practitioner over the existence of material noncompliance and, therefore, not include in its assertion a description of such noncompliance. Alternatively, management may describe noncompliance but not modify its assertion that the entity complied with specified requirements. In such cases, the practitioner should express either a qualified or adverse opinion on management's assertion, depending on the materiality of the noncompliance. In deciding whether to modify the opinion, and whether a modification should be a qualified or adverse opinion, the practitioner should consider such factors as the significance of the noncompliance to the entity and the pervasiveness of the noncompliance.

.66 The following is the form of report a practitioner should use when he or she concludes that a qualified opinion is appropriate in the circumstances.

<u>Independent Accountant's Report</u>

[*Standard introductory and scope paragraphs*]

[*Explanatory paragraph*]

Our examination disclosed the following material noncompliance with [*type of compliance requirement*] applicable to [*name of entity*] during the [*period*] ended [*date*]. [*Describe noncompliance.*]

[*Opinion paragraph*]

In our opinion, except for the material noncompliance described in the third paragraph, management's assertion [*identify management's assertion, for example, that Z Company complied with the aforementioned requirements* *for the year ended December 31, 19X1*] is fairly stated, in all material respects.

.67 The following is the form of report a practitioner should use when he or she concludes that an adverse opinion is appropriate in the circumstances.

Independent Accountant's Report

[*Standard introductory and scope paragraphs*]

[*Explanatory paragraph*]

Our examination disclosed the following material noncompliance with [*type of compliance requirement*] applicable to [*name of entity*] during the [*period*] ended [*date*]. [*Describe noncompliance.*]

[*Opinion paragraph*]

In our opinion, because of the material noncompliance described in the third paragraph, management's assertion [*identify management's assertion, for example, that Z Company complied with the aforementioned requirements for the year ended December 31, 19X1*] is not fairly stated.

.68 If the practitioner issues an examination report on management's assertion about the entity's compliance with specified requirements in the same document that includes his or her audit report on the entity's financial statements, the following sentence should be included in the paragraph of an examination report that describes material noncompliance:

These conditions were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 19XX financial statements, and this report does not affect our report dated [*date of report*] on those financial statements.

The practitioner also may include the preceding sentence when the two reports are not included within the same document.

Material Uncertainty

.69 In certain instances, the outcome of future events that may affect the determination of compliance with specified requirements during a previous period is not susceptible to reasonable estimation by management. When such uncertainties exist, it cannot be determined whether an entity complied with specified requirements and, therefore, whether management's assertion is fairly stated. For example, an entity may be involved in litigation or a regulatory investigation that may, at the time of the engagement, cause the determination of compliance to be uncertain. When such a matter exists and is included in management's assertion, the practitioner should add an explanatory paragraph in his or her report describing the uncertainty. When such a matter exists but is not included in management's assertion, the practitioner should add an explanatory paragraph in his or her report and consider the need for a qualified or adverse opinion.

Management's Representations

.70 In an agreed-upon procedures engagement or an examination engagement, the practitioner should obtain management's written representations[25]—

a. Acknowledging management's responsibility for complying with the specified requirements.

[25] AU section 333, *Client Representations*, paragraph .09 provides guidance on the date as of which management should sign such a representation letter and on which member(s) of management should sign it.

b. Acknowledging management's responsibility for establishing and maintaining an effective internal control structure over compliance.

c. Stating that management has performed an evaluation of (1) the entity's compliance with specified requirements or (2) the entity's internal control policies and procedures for ensuring compliance and detecting noncompliance with requirements, as applicable.

d. Stating management's assertion about the entity's compliance with the specified requirements or about the effectiveness of the internal control structure over compliance, as applicable, based on the stated or established criteria.

e. Stating that management has disclosed to the practitioner all known noncompliance.

f. Stating that management has made available all documentation related to compliance with the specified requirements.

g. Stating management's interpretation of any compliance requirements that have varying interpretations.

h. Stating that management has disclosed any communications from regulatory agencies, internal auditors, and other practitioners concerning possible noncompliance with the specified requirements, including communications received between the end of the period addressed in management's assertion and the date of the practitioner's report.

i. Stating that management has disclosed any known noncompliance occurring subsequent to the period for which, or date as of which, management selects to make its assertion.

.71 Management's refusal to furnish all appropriate written representations constitutes a limitation on the scope of the engagement sufficient to require withdrawal in an agreed-upon procedures engagement and a qualified opinion or disclaimer of opinion in an examination engagement. Further, the practitioner should consider the effects of management's refusal on his or her ability to rely on other management representations.

Other Information in a Client-Prepared Document Containing Management's Assertion About the Entity's Compliance With Specified Requirements or the Effectiveness of the Internal Control Structure Over Compliance

.72 An entity may publish various documents that contain information ("other information") in addition to management's assertion (report) on either (*a*) the entity's compliance with specified requirements or (*b*) the effectiveness of the entity's internal control structure over compliance and the practitioner's report thereon. The practitioner may have performed procedures and issued a report covering the other information. Otherwise, the practitioner's responsibility with respect to other information in such a document does not extend beyond the management report identified in his or her report, and the practitioner has no obligation to perform any procedures to corroborate other information contained in the document. However, the practitioner should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with the information appearing in management's report or whether such information contains a material misstatement of fact.

.73 The practitioner should follow the guidance in paragraphs section 400.81 through .83 if he or she believes the other information is inconsistent with the information appearing in management's report or if he or she becomes aware of information that he or she believes is a material misstatement of fact.

Effective Date

.74 This section is effective for engagements in which management's assertion is as of, or for a period ending, June 15, 1994, or thereafter, except as noted in paragraph .75 Earlier application of this section is encouraged.

.75 For engagements to perform agreed-upon procedures to test a financial institution's compliance with specified safety and soundness laws in accordance with the Federal Deposit Insurance Corporation Improvement Act of 1991, this section should be implemented when management's assertion is as of, or for a period ending, December 31, 1993 or thereafter.

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