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# AICPA Professional Standards: Attestation Standards as of June 1, 2000

American Institute of Certified Public Accountants. Auditing Standards Board

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**AICPA**

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

# ***AICPA Professional Standards***

***Volume 1***

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**U.S. Auditing Standards**

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**Attestation Standards**

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**As of June 1, 2000**

**AT Section****STATEMENTS ON STANDARDS FOR  
ATTESTATION ENGAGEMENTS**

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**[The next page is 2501.]**

# 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 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 (SSARs), 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 planning and 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~~ **reliability of the** assertion ~~is presented in conformity with~~ **based on** 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 **based on** ~~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.

[As amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

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[The next page is 2505.]

\* New language is shown in boldface italics; deleted language is shown by strikethrough.

AT

# 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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[The next page is 2521.]

## AT Section 100

### Attestation Standards

Sources: SSAE No. 1; SSAE No. 4; SSAE No. 5; SSAE No. 7; SSAE No. 9.

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 (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.<sup>1, 2</sup>

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<sup>3</sup> that is the responsibility of another party.<sup>4</sup>

.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.

<sup>1</sup> “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.

<sup>2</sup> Existing authoritative standards that might apply to a particular attest engagement include SASs and SSARs. 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. [As amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

<sup>3</sup> An *assertion* is any declaration, or set of related declarations taken as a whole, by a party responsible for it. A conclusion on the reliability of a written assertion may refer to that assertion, except as discussed in paragraph .53, or to the subject matter to which the assertion relates (see paragraphs .49 through .77). [As amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

<sup>4</sup> 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.

- 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.
- 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 or she 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 another party.

[As amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.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 an assertion. [As amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.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 other 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. [As amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.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.

## The Relationship of Attestation Standards to Quality Control Standards

.06 The independent practitioner is responsible for compliance with the AICPA's Statements on Standards for Attestation Engagements (SSAEs) in an

attest engagement. Rule 202, *Compliance With Standards*, of the Code of Professional Conduct [ET section 202.01], requires members to comply with such standards when conducting professional services. [Paragraph added, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.07 A firm of independent practitioners also needs to comply with the quality control standards<sup>5</sup> in the conduct of a firm's attest practice. Thus, a firm should establish quality control policies and procedures to provide it with reasonable assurance of conforming with attestation standards in its attest engagements. The nature and extent of a firm's quality control policies and procedures depend on factors such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations. [Paragraph added, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.08 *Attestation standards* relate to the conduct of individual *attest engagements*; quality control standards relate to the conduct of a firm's attest practice as a whole. Thus, attestation standards and quality control standards are related and the quality control policies and procedures that a firm adopts may affect both the conduct of individual attest engagements and the conduct of a firm's attest practice as a whole. [Paragraph added, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## General Standards

.09 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.* [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.10 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 assertion. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.11 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.12 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.* [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

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<sup>5</sup> The elements of quality control are identified in Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* [QC section 20]. [Footnote added, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.13 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 express a conclusion about the reliability of an assertion. 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. [Paragraph renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.14 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 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.*

[Paragraph renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.15 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.16 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.17 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 assertion in a sufficiently clear and comprehensive manner for knowledgeable readers to be able to understand them. [Paragraph renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.18 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 assertion generated by such criteria has an appropriate balance of the following characteristics:

a. Relevance

- *Capacity to make a difference in a decision*—The assertion is 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 assertion is useful in confirming or altering the degree of uncertainty about the result of a decision.
- *Timeliness*—The assertion is available to decision makers before it loses its capability to influence decisions.
- *Completeness*—The assertion does not omit information that could alter or confirm a decision.
- *Consistency*—The assertion is 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 assertion corresponds or agrees with the phenomena it purports to represent.
- *Absence of unwarranted inference of certainty or precision*—The assertion 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 assertion rather than its potential effect on a particular interest.
- *Freedom from bias*—The measurements involved in the assertion are equally likely to fall on either side of what they represent rather than more often on one side than the other.

[Paragraph renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.19 Some criteria are reasonable in evaluating an assertion for only a limited number of specified users who participated in their development (specified criteria). 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. [Paragraph renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.20 Even when reasonable criteria exist, the practitioner should consider whether the assertion is also capable of reasonably consistent estimation or

measurement using those criteria.<sup>6</sup> 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 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. [Paragraph renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.21 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.22 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.23 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 inventory existing at a specific location. [Paragraph renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.24 The second condition applies equally whether the practitioner has been engaged to perform an *examination* or a *review* of an assertion (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 limited 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.

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<sup>6</sup> Criteria may yield quantitative or qualitative estimates or measurement. [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

[Paragraph renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.25 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.* [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.26 The practitioner should maintain the intellectual honesty and impartiality necessary to reach an unbiased conclusion about the 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. [Paragraph renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.27 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.28 The fifth general standard is—*Due professional care shall be exercised in the planning and performance of the engagement.* [Paragraph renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.29 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.30 *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 pretensions 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.<sup>7</sup>

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

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<sup>7</sup> D. Haggard, *Cooley on Torts*, 472 (4th ed., 1932). [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

## Standards of Fieldwork

**.31** The first standard of fieldwork is—*The work shall be adequately planned and assistants, if any, shall be properly supervised.* [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

**.32** 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

**.33** 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 assertion. [Paragraph renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

**.34** Factors to be considered by the practitioner in planning an attest engagement include the following:

- a. The presentation criteria to be used
- b. The anticipated level of attestation risk<sup>8</sup> related to the assertion on which he or she will report
- c. Preliminary judgments about materiality levels for attest purposes
- d. The items within the assertion that are likely to require revision or adjustment
- e. Conditions that may require extension or modification of attest procedures
- f. The nature of the report expected to be issued

[Paragraph renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

**.35** The practitioner should establish an understanding with the client regarding the services to be performed for each engagement.<sup>9</sup> Such an understanding reduces the risk that either the practitioner or the client may misinterpret the needs or expectations of the other party. For example, it reduces the risk that the client may inappropriately rely on the practitioner to protect

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<sup>8</sup> *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). [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

<sup>9</sup> See SQCS No. 2, paragraph 16 [QC section 20.16]. [Footnote added, effective for engagements for periods ending on or after June 15, 1998, by Statement on Standards for Attestation Engagements No. 7. Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

the entity against certain risks or to perform certain functions that are the client's responsibility. The understanding should include the objectives of the engagement, management's responsibilities, the practitioner's responsibilities, and limitations of the engagement. The practitioner should document the understanding in the working papers, preferably through a written communication with the client. If the practitioner believes an understanding with the client has not been established, he or she should decline to accept or perform the engagement. [Paragraph added, effective for engagements for periods ending on or after June 15, 1998, by Statement on Standards for Attestation Engagements No. 7. Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.36 The nature, extent, and timing of planning will vary with the nature and complexity of the assertion and the practitioner's prior experience with management. 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.37 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 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.38 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.39 The work performed by each assistant should be reviewed to determine if it was adequately performed and to evaluate whether the results are consistent with the conclusion to be presented in the practitioner's report. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.40 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.* [Paragraph renumbered by the issuance of Statement on Standards for

Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.41 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 the more assurance it provides about the reliability of the assertion.

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.42 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.43 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.44 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). [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.45 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.46 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 be tested to the assertion 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

[.47-.48] [Superseded by Statement on Standards for Attestation Engagements No. 4, effective for reports on agreed-upon procedures engagements dated after April 30, 1996 (see section 600). Paragraphs renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraphs subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

## Standards of Reporting

.49 The first standard of reporting is—*The report shall identify the assertion being reported on and state the character of the engagement.* [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.50 The practitioner who accepts an attest engagement should issue a report on the assertion or the subject matter to which the assertion relates or withdraw from the attest engagement. Management's assertion should be bound with or accompany the practitioner's report or the assertion should be

clearly stated in the practitioner's report. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.51 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 audit in accordance with GAAS), that form should be used in the practitioner's report. However, when no such interpretive standards exist, (a) the terms *examination* and *review* should be used to describe engagements to provide, respectively, the highest level and a moderate level of assurance, and (b) the reference to professional standards should be accomplished by referring to "standards established by the American Institute of Certified Public Accountants." [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.52 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.53 The second standard of reporting is—*The report shall state the practitioner's conclusion about the reliability of the assertion based on the established or stated criteria against which it was measured.* A conclusion on the reliability of a written assertion may refer to that assertion or to the subject matter to which the assertion relates. However, if conditions exist that, individually or in combination, result in one or more material deviations from the criteria, the practitioner should modify the report and, to most effectively communicate with the reader of the report, should ordinarily express his or her conclusion directly on the subject matter,<sup>10</sup> not on management's assertion. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.54 The practitioner should consider the concept of materiality in applying this standard. In expressing a conclusion on the reliability of the assertion based on the established or stated criteria against which it was measured, the

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<sup>10</sup> Specific standards may require that the practitioner express his or her conclusion directly on the subject matter. For example, if management states in its assertion that a material weakness exists in the entity's internal control over financial reporting, the practitioner should state his or her opinion directly on the effectiveness of internal control, not on management's assertion related thereto. [Footnote added, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]



practitioner should consider an omission or a misstatement to be material if the omission or misstatement—individually or when aggregated with others—is such that a reasonable person relying on the assertion would be influenced by the omission or misstatement. The relative, rather than absolute, size of an omission or misstatement determines whether it is material in a given situation. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.55 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*). [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.56 In an engagement to achieve the highest level of assurance (an *examination*), the practitioner's conclusion should be expressed in the form of an 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## Examination

.57 When expressing an opinion, the practitioner should clearly state whether, in his or her opinion, (a) management's assertion is presented [*or fairly stated*], in all material respects, based on [*or in conformity with*] the established or stated criteria or (b) the subject matter of the assertion is based on [*or in conformity with*] the established or stated criteria in all material respects. Reports expressing an opinion on the reliability of an assertion, however, may be qualified or modified for some aspect of the assertion or the engagement (see the third reporting standard). In addition, such reports may emphasize certain matters relating to the attest engagement or the assertion. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.58 The practitioner's report on an examination should include the following:

- a. A title that includes the word *independent*
- b. An identification of management's assertion (When management's assertion does not accompany the practitioner's report, the first paragraph of the report should also contain a statement of management's assertion.)
- c. A statement that the assertion is the responsibility of management
- d. A statement that the practitioner's responsibility is to express an opinion on management's assertion [*or the subject matter of management's assertion*] based on his or her examination

- e. A statement that the examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants, and, accordingly, included procedures that the practitioner considered necessary in the circumstances
- f. A statement that the practitioner believes the examination provides a reasonable basis for his or her opinion
- g. The practitioner's opinion on whether—
  - (1) Management's assertion is presented [*or fairly stated*], in all material respects, based on [*or in conformity with*] the established or stated<sup>11</sup> criteria, or
  - (2) The subject matter of the assertion is based on [*or in conformity with*] the established or stated criteria in all material respects.
- h. When the assertion has been prepared based on specified criteria that have been agreed upon by the asserter and the specified parties, the practitioner's report should also contain—
  - (1) A statement of limitations on the use of the report because it is intended solely for specified parties (see the fourth reporting standard)
  - (2) A statement, when established criteria exist, that the assertion is not intended to be that which would have been presented if the assertion were presented based on [*identify established criteria*]
- i. The manual or printed signature of the practitioner's firm
- j. The date of the examination report

[Paragraph added, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

**.59** The form of the practitioner's report will depend on the following:

- a. Whether the practitioner opines on management's assertion or the subject matter of management's assertion
- b. Whether management's assertion is presented separately and accompanies the practitioner's report or whether management's assertion is only stated in the practitioner's report

The report examples included in this section assume that management's assertion accompanies the practitioner's report. AT section 400, *Reporting on an Entity's Internal Control Over Financial Reporting*, and AT section 500, *Compliance Attestation*, provide report examples for when management's assertion accompanies the practitioner's report and when there is no accompanying assertion. They also provide examples of reports that express an opinion on management's assertion or on the subject matter of management's assertion. [Paragraph added, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

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<sup>11</sup> Stated criteria also include specified criteria as described in paragraph .19. [Footnote added, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

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

Independent Accountant's Report

We have examined the accompanying [identify the assertion—for example, *Statement of Investment Performance Statistics of XYZ Fund for the year ended December 31, 19XX*]. This statement is the responsibility of the Fund's management. Our responsibility is to express an opinion on this statement based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining on a test basis, evidence supporting the [identify the assertion—for example, *Statement of Investment Performance Statistics*] and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

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

In our opinion, the [identify the assertion—for example, *Statement of Investment Performance Statistics*] referred to above presents [identify the subject matter of the assertion—for example, *the investment performance of XYZ Fund for the year ended December 31, 19XX*], in all material respects, based on [identify established or stated criteria—for example, *the measurement and disclosure criteria set forth in Note 1*].

[Signature]

[Date]

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

[.61] [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered and deleted by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

## Review

.62 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 assertion is not presented in all material respects based on established or stated criteria. (As discussed more fully in the commentary to the third reporting standard, if the assertion is 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.) [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

[.63] [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered and deleted by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

- .64 The practitioner's report on a review should include the following:
- a. A title that includes the word *independent*
  - b. An identification of management's assertion (When management's assertion does not accompany the practitioner's report, the first paragraph of the report should also contain a statement of management's assertion.)
  - c. A statement that the assertion is the responsibility of management
  - d. A statement that the review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants
  - e. A statement that a review is substantially less in scope than an examination, the objective of which is an expression of opinion on the assertion (or subject matter of the assertion), and accordingly, no such opinion is expressed
  - f. A statement about whether the practitioner is aware of any material modifications that should be made to the assertion in order for it to be presented [*or fairly stated*], in all material respects, based on [*or in conformity with*] the established or stated<sup>12</sup> criteria, other than those modifications, if any, indicated in his or her report or a statement about whether the practitioner is aware of any material modifications that should be made to the subject matter of the assertion in order for it to be based on [*or in conformity with*], in all material respects, the established or stated<sup>13</sup> criteria, other than those modifications, if any, indicated in his or her report
  - g. If the assertion has been prepared based on specified criteria that have been agreed upon by the asserter and the specified users, the practitioner's report should also contain—
    - (1) A statement of limitations on the use of the report because it is intended solely for specified parties (see the fourth reporting standard)
    - (2) A statement, when established criteria exist, that the assertion is not intended to be that which would have been presented if the assertion were presented based on [*identify established criteria*]
  - h. The manual or printed signature of the practitioner's firm
  - i. The date of the review report

[Paragraph added, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

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<sup>12</sup> Stated criteria also include specified criteria as described in paragraph .19. [Footnote added, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

<sup>13</sup> Stated criteria also include specified criteria as described in paragraph .19. [Footnote added, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.65 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:

#### Independent Accountant's Report

We have reviewed the accompanying [identify the assertion—for example, *Statement of Investment Performance Statistics of XYZ Fund for the year ended December 31, 19XX*]. This statement is the responsibility of the Fund's management.

Our review was conducted in accordance with attestation 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 assertion—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 assertion.]

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

[Signature]

[Date]

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

### Agreed-Upon Procedures

[.66–.69] [Superseded by Statement on Standards for Attestation Engagements No. 4, effective for reports on agreed-upon procedures engagements dated after April 30, 1996 (see section 600). Paragraphs renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraphs subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]<sup>[14]</sup>

### Other Reporting Requirements

.70 The third standard of reporting is—*The report shall state all of the practitioner's significant reservations about the engagement and the assertion.* [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

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<sup>[14]</sup> [Superseded by Statement on Standards for Attestation Engagements No. 4, effective for reports on agreed-upon procedures engagements dated after April 30, 1996 (see section 600). Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Footnote subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.71 "Reservations about the engagement" refers to any unresolved problem that the practitioner had in complying with 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). [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.72 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.73 The practitioner's decision to provide a qualified opinion, to disclaim an opinion, 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 assertion. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question, by their significance to the assertion, and by whether the engagement is an examination or a review. If the potential effects are pervasive to the assertion or if the practitioner is performing a review, a disclaimer of opinion 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 an opinion on the assertion or withdraw from the engagement. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.74 "Reservations about the assertion" refers to any unresolved reservation about whether the assertion is fairly stated, in all material respects, based on established or stated criteria, including the adequacy of the disclosure of material matters. They can result in either a qualified or an adverse opinion, depending on the materiality of the departure from the criteria against which the assertion was evaluated. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.75 Reservations about the assertion may relate to the measurement, form, arrangement, content, or underlying judgments and assumptions applicable to the assertion 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 or an adverse report given the

circumstances and facts of which he or she is aware at the time. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.76 The fourth standard of reporting is—*The report on an engagement to evaluate an assertion that has been prepared based on 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.* [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.77 Certain reports should be restricted to specified users who have participated in establishing either the criteria against which the assertion was 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

## Working Papers

.78 The practitioner should prepare and maintain working papers in connection with an engagement under the attestation standards; such working papers should be appropriate to the circumstances and the practitioner’s needs on the engagement to which they apply.<sup>15</sup> Although the quantity, type, and content of working papers will vary with the circumstances, they ordinarily should indicate that—

- a. The work was adequately planned and supervised, indicating observance of the first standard of fieldwork.
- b. Evidential matter was obtained to provide a reasonable basis for the conclusion or conclusions expressed in the practitioner’s report.

[Paragraph added, effective for engagements beginning after December 15, 1995, by Statement on Standards for Attestation Engagements No. 5. Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.79 Working papers are records kept by the practitioner of the work performed, the information obtained, and the pertinent conclusions reached in the engagement. Examples of working papers are work programs, analyses,

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<sup>15</sup> There is no intention to imply that the practitioner would be precluded from supporting his or her report by other means in addition to working papers. [Footnote added, effective for engagements beginning after December 15, 1995, by Statement on Standards for Attestation Engagements No. 5. Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Footnote subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

memoranda, letters of confirmation and representation, abstracts of the entity's documents, and schedules or commentaries prepared or obtained by the practitioner. Working papers also may be in the form of data stored on tapes, films, or other media. [Paragraph added, effective for engagements beginning after December 15, 1995, by Statement on Standards for Attestation Engagements No. 5. Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.80 Working papers are the property of the practitioner, and some states have statutes or regulations that designate the practitioner as the owner of the working papers. The practitioner's rights of ownership, however, are subject to ethical limitations relating to the confidential relationship with the clients. [Paragraph added, effective for engagements beginning after December 15, 1995, by Statement on Standards for Attestation Engagements No. 5. Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.81 Certain of the practitioner's working papers may sometimes serve as a useful reference source for his or her client, but the working papers should not be regarded as a part of or a substitute for the client's records. [Paragraph added, effective for engagements beginning after December 15, 1995, by Statement on Standards for Attestation Engagements No. 5. Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.82 The practitioner should adopt reasonable procedures for safe custody of his or her working papers and should retain them for a period of time sufficient to meet the needs of his or her practice and to satisfy any pertinent legal requirements of records retention. [Paragraph added, effective for engagements beginning after December 15, 1995, by Statement on Standards for Attestation Engagements No. 5. Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

## Attest Services Related to MAS Engagements\*

### Attest Services as Part of an MAS Engagement

.83 When a practitioner<sup>16</sup> provides an attest service (as defined in this section) as part of an MAS engagement, the Statements on Standards for Attest-

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\* The terminology in this section is based on Statements on Standards for Management Advisory Services (SSMAS). The SSMASS were superseded by Statement on Standards for Consulting Services (SSCS) No. 1, *Consulting Services: Definitions and Standards* (CS section 100), 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.

<sup>16</sup> *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 the issuance of Statement on Auditing Standards No. 72, February 1993. Footnote subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 5, November 1995. Footnote subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Footnote subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]



ation Engagements<sup>17</sup> apply only to the attest service. Statements on Standards for Management Advisory Services (SSMASs) apply to the balance of the Management Advisory Services (MAS) engagement.<sup>18</sup> [Paragraph added, effective for attest reports issued on or after May 1, 1988, by Statement on Standards for Attestation Engagements, *Attest Services Related to MAS Engagements*. Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 5, November 1995. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.84 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. [Paragraph added, effective for attest reports issued on or after May 1, 1988, by Statement on Standards for Attestation Engagements, *Attest Services Related to MAS Engagements*. Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 5, November 1995. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.85 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. [Paragraph added, effective for attest reports issued on or after May 1, 1988, by Statement on Standards for Attestation Engagements, *Attest Services Related to MAS Engagements*. Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 5, November 1995. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

## Assertions, Criteria, and Evidence

.86 An attest service may involve written assertions, evaluation criteria, or evidential matter developed during a concurrent or prior MAS engagement.

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<sup>17</sup> This refers to SSAE No. 1, *Attestation Standards*, and subsequent statements in that series, as issued by the AICPA. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 72, February 1993. Footnote subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 5, November 1995. Footnote subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Footnote subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

<sup>18</sup> 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 the issuance of Statement on Auditing Standards No. 72, February 1993. Footnote subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 5, November 1995. Footnote subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Footnote subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

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. [Paragraph added, effective for attest reports issued on or after May 1, 1988, by Statement on Standards for Attestation Engagements, *Attest Services Related to MAS Engagements*. Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 5, November 1995. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

### Nonattest Evaluations of Written Assertions

.87 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. [Paragraph added, effective for attest reports issued on or after May 1, 1988, by Statement on Standards for Attestation Engagements, *Attest Services Related to MAS Engagements*. Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 5, November 1995. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

### Effective Date

.88 Paragraphs .01 through .34 and .36 through .77 are effective for attest reports issued on or after September 30, 1986. Earlier application is encouraged. Paragraph .35 is effective for engagements for periods ending on or after June 15, 1998. Earlier application is permitted. Paragraphs .78 through .82 are effective for engagements beginning after December 15, 1995. Paragraphs .83 through .87 are effective for attest reports issued on or after May 1, 1988. The amendments to this section are effective for reports issued on or after June 30, 1999; earlier application is encouraged. [Paragraph renumbered and amended, effective for attest reports issued on or after May 1, 1988, by the issuance of

Statement on Standards for Attestation Engagements, *Attest Services Related to MAS Engagements*. Paragraph subsequently renumbered and amended, effective for engagements beginning after December 15, 1995, by the issuance of Statement on Standards for Attestation Engagements No. 5. Paragraph subsequently renumbered and amended, effective for engagements for periods ending on or after June 15, 1998, by the issuance of Statement on Standards for Attestation Engagements No. 7. Paragraph subsequently renumbered and amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

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 Statement on Auditing Standards Nos. 53 through 72.

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## Appendix A

### 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 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.
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.

1. The examination is to be performed by a person or persons having adequate training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
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 shall 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.

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements, *Attest Services Related to MAS Engagements*, December 1987. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 5, November 1995. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

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 Statement on Auditing Standards Nos. 53 through 72 or SSAE No. 2.

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## Appendix B

### 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.

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements, *Attest Services Related to MAS Engagements*, December 1987. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 5, November 1995. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 7, October 1997. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

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[The next page is 2551.]

## 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 section 100, *Attestation Standards*?

**.04 Interpretation**—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, section 100 applies to such engagements.

**.05 Question**—Section 100.14 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 section 100.18.

.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 section 100.16. Consequently, as required by section 100.17, 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. Section 100.70 through .73 provides 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 section 100?

.17 *Interpretation*—The standards of reporting in section 100.49 through .77 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. Section 100.50 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 and .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

### 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

### 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

### 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

# 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.

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\* 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 re-

garding, 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

### 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 or 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

### 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.<sup>1</sup> The lender is concerned that such financings not be considered to include a fraudulent conveyance or transfer under the Federal Bankruptcy Code<sup>2</sup> or the relevant state fraudulent conveyance or transfer statute.<sup>3</sup> 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 section 100, *Attestation Stan-*

<sup>1</sup> 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.

<sup>2</sup> 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).

<sup>3</sup> 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.

*dards.* The third 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 section 100, which was 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 AR section 100, *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, *Engagements to Apply 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.)<sup>[4]</sup>

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

### 3. Applicability of Attestation Standards to Litigation Services

.47 *Question*—Section 100, *Attestation Standards*, paragraph .02, provides examples of litigation services provided by practitioners that would not be considered attest engagements as defined by section 100. When does section 100 not apply to litigation service engagements?

.48 *Interpretation*—Section 100 does not apply to litigation services that involve pending or potential formal legal or regulatory proceedings before a “trier of fact”<sup>5</sup> 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.

<sup>[4]</sup> [Footnote deleted.]

<sup>5</sup> 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 section 100 apply to litigation service engagements?

**.50 Interpretation**—Section 100 applies 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 section 100.

**.51 Question**—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 section 100.02*f* mean?

**.52 Interpretation**—The term “stipulated facts” as used in 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 through .46), prohibit a practitioner from providing expert testimony, as described in 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 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 through .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 through .46 does not apply in such engagements because as 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.]

#### 4. Providing Access to or Photocopies of Working Papers to a Regulator

.56 *Question*—Interpretation No. 1 to AU section 339, *Working Papers*, entitled “Providing Access to or Photocopies of Working Papers to a Regulator” [AU section 9339.01–.15], contains guidance relating to providing access to or photocopies of working papers to a regulator. Is this guidance applicable to an attestation engagement when a regulator requests access to or photocopies of the working papers?

.57 *Interpretation*—Yes. The guidance in Interpretation No. 1 to AU section 339 [AU section 9339.01–.15] is applicable in these circumstances; however, the letter to a regulator should be tailored to meet the individual engagement characteristics or the purpose of the regulatory request, for example, a quality control review. Illustrative letters for an examination engagement performed in accordance with section 500, *Compliance Attestation*, and an agreed-upon procedures engagement performed in accordance with section 600, *Agreed-Upon Procedures Engagements*, follow.

.58 Illustrative letter for examination engagement:

##### Illustrative Letter to Regulator<sup>6</sup>

(Date)

(Name and Address of Regulatory Agency)

Your representatives have requested access to our working papers in connection with our engagement to examine management’s assertion that (*management’s assertion*). It is our understanding that the purpose of your request is (*state purpose*: for example, “to facilitate your regulatory examination”).<sup>7</sup>

Our examination was performed in accordance with standards<sup>8</sup> established by the American Institute of Certified Public Accountants, the objective of which is to form an opinion as to whether management’s assertion is fairly stated, in all material respects, based on (*identify established or stated criteria*). Under these standards, we have the responsibility to plan and perform our examination to provide a reasonable basis for our opinion and to exercise due professional care in the performance of our examination. Our examination is subject to the inherent risk that material noncompliance, if it exists, would not be detected. In addition, our examination does not address the possibility that

<sup>6</sup> The practitioner should appropriately modify this letter when the engagement has been performed in accordance with the Statements on Standards for Attestation Engagements and also in accordance with additional attest requirements specified by a regulatory agency (for example, the requirements specified in *Government Auditing Standards* issued by the Comptroller General of the United States).

<sup>7</sup> If the practitioner is not required by law, regulation, or engagement contract to provide a regulator access to the working papers but otherwise intends to provide such access (see AU section 9339.11–.15), the letter should include a statement that: “Management of (*name of entity*) has authorized us to provide you access to our working papers for (*state purpose*).”

<sup>8</sup> Refer to footnote 6.

material noncompliance may occur in the future. Also, our use of professional judgment and the assessments of attestation risk and materiality for the purpose of our examination means that matters may have existed that would have been assessed differently by you. Our examination does not provide a legal determination on (*name of entity*)'s compliance with specified requirements.

The working papers were prepared for the purpose of providing the principal support for our opinion on management's assertion and to aid in the performance and supervision of our examination. The working papers document the procedures performed, the information obtained, and the pertinent conclusions reached in the examination. The procedures that we performed were limited to those we considered necessary under standards<sup>9</sup> established by the American Institute of Certified Public Accountants to provide us with reasonable basis for our opinion. Accordingly, we make no representation as to the sufficiency or appropriateness, for your purposes, of either the procedures or information documented in our working papers. In addition, any notations, comments, and individual conclusions appearing on any of the working papers do not stand alone and should not be read as an opinion on any part of management's assertion or the related subject matter.

Our examination was performed for the purpose stated above and was not planned or performed in contemplation of your (*state purpose*: for example, "regulatory examination"). Therefore, items of possible interest to you may not have been specifically addressed. Accordingly, our examination, and the working papers prepared in connection therewith, should not supplant other inquiries and procedures that should be undertaken by the (*name of regulatory agency*) for the purpose of monitoring and regulating (*name of entity*). In addition, we have not performed any procedures since the date of our report with respect to management's assertion, and significant events or circumstances may have occurred since that date.

The working papers constitute and reflect work performed or information obtained by us in the course of our examination. The documents contain trade secrets and confidential commercial and financial information of our firm and (*name of entity*) that is privileged and confidential, and we expressly reserve all rights with respect to disclosures to third parties. Accordingly, we request confidential treatment under the Freedom of Information Act or similar laws and regulations when requests are made for the working papers or information contained therein or any documents created by the (*name of regulatory agency*) containing information derived therefrom. We further request that written notice be given to our firm before distribution of the information in the working papers (or photocopies thereof) to others, including other governmental agencies, except when such distribution is required by law or regulation.<sup>10</sup>

*[If it is expected that photocopies will be requested, add:*

Any photocopies of our working papers we agree to provide you will contain a legend "Confidential Treatment Requested by (*name of practitioner, address, telephone number*)."]

*Firm signature*

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<sup>9</sup> Refer to footnote 6.

<sup>10</sup> This illustrative paragraph may not in and of itself be sufficient to gain confidential treatment under the rules and regulations of certain regulatory agencies. The practitioner should consider tailoring this paragraph to the circumstances after consulting the regulations of each applicable regulatory agency and, if necessary, consult with legal counsel regarding the specific procedures and requirements necessary to gain confidential treatment.

**.59 Example letter for agreed-upon procedures engagements:****Illustrative Letter to Regulator<sup>11</sup>**

(Date)

(Name and Address of Regulatory Agency)

Your representatives have requested access to our working papers in connection with our engagement to perform agreed-upon procedures on management's assertion that (*management's assertion*). It is our understanding that the purpose of your request is (*state purpose*: for example, "to facilitate your regulatory examinations").<sup>12</sup>

Our agreed-upon procedures engagement was performed in accordance with standards<sup>13</sup> established by the American Institute of Certified Public Accountants. Under these standards, we have the responsibility to perform the agreed-upon procedures to provide a reasonable basis for the findings expressed in our report. We were not engaged to, and did not, perform an examination, the objective of which would be to form an opinion on management's assertion. Our engagement is subject to the inherent risk that material misstatement of management's assertion, if it exists, would not be detected. (*The practitioner may add the following*: "In addition, our engagement does not address the possibility that material misstatement of management's assertion may occur in the future.") The procedures that we performed were limited to those agreed to by the specified users, and the sufficiency of these procedures is solely the responsibility of the specified users of the report. Further, our engagement does not provide a legal determination on (*name of entity*)'s compliance with specified requirements.

The working papers were prepared to document the agreed-upon procedures performed, the information obtained, and the pertinent findings reached in the engagement. Accordingly, we make no representation, for your purposes, as to the sufficiency or appropriateness of the information documented in our working papers. In addition, any notations, comments, and individual findings appearing on any of the working papers should not be read as an opinion on management's assertion or the related subject matter, or any part thereof.

Our engagement was performed for the purpose stated above and was not performed in contemplation of your (*state purpose*: for example, "regulatory examination"). Therefore, items of possible interest to you may not have been specifically addressed. Accordingly, our engagement, and the working papers prepared in connection therewith, should not supplant other inquiries and procedures that should be undertaken by the (*name of regulatory agency*) for the purpose of monitoring and regulating (*name of client*). In addition, we have not performed any procedures since the date of our report with respect to management's assertion, and significant events or circumstances may have occurred since that date.

The working papers constitute and reflect work performed or information obtained by us in the course of our engagement. The documents contain trade secrets and confidential commercial and financial information of our firm and (*name of client*) that is privileged and confidential, and we expressly reserve

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<sup>11</sup> The practitioner should appropriately modify this letter when the engagement has been performed in accordance with the Statements on Standards for Attestation Engagements and also in accordance with additional attest requirements specified by a regulatory agency (for example, the requirements specified in *Government Auditing Standards* issued by the Comptroller General of the United States).

<sup>12</sup> If the practitioner is not required by law, regulation or engagement contract to provide a regulator access to the working papers but otherwise intends to provide such access (see AU section 9339.11-.15) the letter should include a statement that: "Management of (*name of entity*) has authorized us to provide you access to our working papers for (*state purpose*)."

<sup>13</sup> Refer to footnote 6.

all rights with respect to disclosures to third parties. Accordingly, we request confidential treatment under the Freedom of Information Act or similar laws and regulations when requests are made for the working papers or information contained therein or any documents created by the (*name of regulatory agency*) containing information derived therefrom. We further request that written notice be given to our firm before distribution of the information in the working papers (or photocopies thereof) to others, including other governmental agencies, except when such distribution is required by law or regulation.<sup>14</sup>

*[If it is expected that photocopies will be requested, add:*

Any photocopies of our working papers we agree to provide you will contain a legend "Confidential Treatment Requested by (*name of practitioner, address, telephone number*)."]

*Firm signature*

[Issue Date: May, 1996.]

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[The next page is 2601.]

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<sup>14</sup> This illustrative paragraph may not in and of itself be sufficient to gain confidential treatment under the rules and regulations of certain regulatory agencies. The practitioner should consider tailoring this paragraph to the circumstances after consulting the regulations of each applicable regulatory agency and, if necessary, consult with legal counsel regarding the specific procedures and requirements necessary to gain confidential treatment.

## AT Section 200

### ***Financial Forecasts and Projections***

Source: SSAE No. 1; SSAE No. 4.

**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.<sup>[1]</sup> 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<sup>2</sup> 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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<sup>[1]</sup> Footnote deleted.

<sup>2</sup> 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.<sup>3</sup> 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<sup>4</sup> and partial presentations<sup>5</sup> 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 cash flows. 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 may be expressed in

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<sup>3</sup> 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."

<sup>4</sup> 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 No. 1, *Attestation Standards*, "Reporting on Pro Forma Financial Information."]

<sup>5</sup> Partial presentations are presentations that do not meet the minimum presentation guidelines in paragraph .67 of this section.



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 cash flows. 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.<sup>6</sup> 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 in-

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<sup>6</sup> AU section 623, *Special Reports*, discusses comprehensive bases of accounting other than generally accepted accounting principles.

terests. 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,<sup>7</sup> 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<sup>8</sup> 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.

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<sup>7</sup> See paragraph .68, paragraph 5, for the required procedures.

<sup>8</sup> AICPA presentation guidelines are detailed in the *AICPA Guide for Prospective Financial Information*.

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

- 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.<sup>9</sup> (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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<sup>9</sup> 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.<sup>10</sup>

We have compiled the accompanying forecasted balance sheet, statements of income, retained earnings, and cash flows 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.<sup>11</sup>

A compilation is limited to presenting in the form of a forecast information that is the representation of management<sup>12</sup> 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 cash flows 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.<sup>13</sup>

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.

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<sup>10</sup> 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.

<sup>11</sup> 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."

<sup>12</sup> 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.

<sup>13</sup> 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."

**.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 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.<sup>14</sup> 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.<sup>15</sup> In addition, the historical financial statements that appear in the document may be summarized and presented with the prospective financial statements for comparative purposes.<sup>16</sup> 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 re-

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<sup>14</sup> 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).

<sup>15</sup> 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.

<sup>16</sup> 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.

port. 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.<sup>17</sup> For example, the accountant should not include statements in his 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.<sup>18</sup>
- 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

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<sup>17</sup> 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.)

<sup>18</sup> AICPA presentation guidelines are detailed in the *AICPA Guide for Prospective Financial Information*.

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 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<sup>19</sup> 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 cash flows of XYZ Company as of December 31, 19XX, and for the year then ending.<sup>20</sup> Our examination was made in accordance with standards for an examination of a forecast established by the Amer-

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<sup>19</sup> 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 Information*.

<sup>20</sup> 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."

ican 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 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 cash flows of XYZ Company as of December 31, 19XX, and for the year then ending.<sup>21</sup> 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.

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<sup>21</sup> 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."



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 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).<sup>22</sup> 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 cash flows 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.

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<sup>22</sup> 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.

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. 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,<sup>23</sup> 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 cash flows 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.

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<sup>23</sup> 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.

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 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 cash flows 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.<sup>24</sup> In addition, the historical financial statements that appear in the document may be summarized and presented with the prospective financial statements for comparative purposes.<sup>25</sup> 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.<sup>26</sup>

- 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 fi-

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<sup>24</sup> 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.

<sup>25</sup> 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.

<sup>26</sup> 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).

- 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 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 cash flows.
  - 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 engaged to perform agreed-upon procedures on prospective financial statements should follow the guidance set forth herein and in section 600, *Agreed-Upon Procedures Engagements*. [As amended, effective

for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4.] (See section 600.)

**.50** An accountant may perform an agreed-upon procedures attestation engagement to prospective financial statements<sup>27</sup> provided that—

- a. The accountant is independent.
- b. The accountant and the specified users agree upon the procedures performed or to be performed by the accountant.
- c. The specified users take responsibility for the sufficiency of the agreed-upon procedures for their purposes.
- d. The prospective financial statements include a summary of significant assumptions.
- e. The prospective financial statements to which the procedures are to be applied are subject to reasonably consistent estimation or measurement.
- f. Criteria<sup>28</sup> to be used in the determination of findings are agreed upon between the accountant and the specified users.
- g. The procedures to be applied to the prospective financial statements are expected to result in reasonably consistent findings using the criteria.
- h. Evidential matter related to the prospective financial statements to which the procedures are applied is expected to exist to provide a reasonable basis for expressing the findings in the accountant's report.
- i. Where applicable, a description of any agreed-upon materiality limits for reporting purposes (see section 600.27).
- j. Use of the report is to be restricted to the specified users.<sup>29</sup>

[As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4.] (See section 600.)

**.51** The accountant who accepts an engagement to apply agreed-upon procedures to prospective financial statements should (a) have adequate technical training and proficiency to apply agreed-upon procedures to prospective financial statements; (b) adequately plan the engagement and supervise the work of assistants, if any; and (c) obtain sufficient evidence to provide a reasonable basis for his report on the results of applying agreed-upon procedures. [As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4.] (See section 600.)

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<sup>27</sup> 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. (AU section 634.44.) [Footnote added, effective for comfort letters issued on or after June 30, 1993, by the issuance of Statement on Auditing Standards No. 72.] (See AU section 634.)

<sup>28</sup> For example, accounting principles and other presentation criteria as discussed in chapter 8, "Presentation Guidelines," of the AICPA Audit and Accounting Guide *Guide for Prospective Financial Information*. [Footnote added, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4.] (See section 600.)

<sup>29</sup> An accountant may perform an engagement pursuant to which his report will be a matter of public record (see section 600.33). [Footnote added, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4.] (See section 600.)

.52 Generally, the accountant's procedures may be as limited or as extensive as the specified users desire, as long as the specified users take responsibility for their sufficiency. However, mere reading of prospective financial statements does not constitute a procedure sufficient to permit an accountant to report on the results of applying agreed-upon procedures to such statements. [As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4.] (See section 600.)

.53 To satisfy the requirements that the accountant and the specified users agree upon the procedures performed or to be performed and that the specified users take responsibility for the sufficiency of the agreed-upon procedures for their purposes, ordinarily the accountant should communicate directly with and obtain affirmative acknowledgment from each of the specified users. For example, this may be accomplished by meeting with the specified users or by distributing a draft of the anticipated report or a copy of an engagement letter to the specified users and obtaining their agreement. If the accountant is not able to communicate directly with all of the specified users, the accountant may satisfy these requirements by applying any one or more of the following or similar procedures:

- Compare the procedures to be applied to written requirements of the specified users.
- Discuss the procedures to be applied with appropriate representatives of the specified users involved.
- Review relevant contracts with or correspondence from the specified users.

The accountant should not report on an engagement when specified users do not agree upon the procedures performed or to be performed and do not take responsibility for the sufficiency of the procedures for their purposes. (See section 600.38 for guidance on satisfying these requirements when the accountant is requested to add parties as specified users after the date of completion of the agreed-upon procedures.) [As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4.] (See section 600.)

### Reports on the Results of Applying Agreed-Upon Procedures

.54 The accountant's report on the results of applying agreed-upon procedures should be in the form of procedures and findings. The accountant's report should contain the following elements:

- a. A title that includes the word *independent*
- b. Identification of the specified users
- c. Reference to the prospective financial statements covered by the accountant's report and the character of the engagement
- d. A statement that the procedures performed were those agreed to by the specified users identified in the report
- e. Reference to standards established by the American Institute of Certified Public Accountants
- f. A statement that the sufficiency of the procedures is solely the responsibility of the specified users and a disclaimer of responsibility for the sufficiency of those procedures
- g. A list of the procedures performed (or reference thereto) and related findings (The accountant should not provide negative assurance—see section 600.26.)



- h.* Where applicable, a description of any agreed-upon materiality limits (see section 600.27)
- i.* A statement that the accountant was not engaged to, and did not, perform an examination of prospective financial statements; a disclaimer of 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; and a statement that if the practitioner had performed additional procedures, other matters might have come to his or her attention that would have been reported
- j.* A statement of restrictions on the use of the report because it is intended to be used solely by the specified users (However, if the report is a matter of public record, the accountant should include the following sentence: "However, this report is a matter of public record and its distribution is not limited.")
- k.* Where applicable, reservations or restrictions concerning procedures or findings as discussed in section 600.35, .37, .41, and .42
- l.* A caveat that the prospective results may not be achieved
- m.* A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report
- n.* Where applicable, a description of the nature of the assistance provided by a specialist as discussed in section 600.21 through .23

[As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4.] (See section 600.)

[.55-.56] [Superseded by Statement on Standards for Attestation Engagements No. 4, effective for reports on agreed-upon procedures engagements dated after April 30, 1996.] (See section 600.)

.57 The following illustrates a report on applying agreed-upon procedures to the prospective financial statements.

Independent Accountant's Report  
on Applying Agreed-Upon Procedures

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 and the related forecasted statements of income, retained earnings, and cash flows of DEF Company, a subsidiary of ABC Company, as of December 31, 19XX, and for the year then ending. These procedures, which were agreed to by the Boards of Directors of XYZ Corporation and ABC Company, were performed solely to assist you in evaluating the forecast in connection with the proposed sale of DEF Company to XYZ Corporation. This agreed-upon procedures engagement was performed in accordance with standards established by the American Institute of Certified Public Accountants. 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.]*

We were not engaged to, and did not, perform an examination, the objective of which would be the expression of an opinion on the accompanying prospective financial statements. Accordingly, 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. Had we performed additional procedures, other 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.

This report is intended solely for the use of the Boards of Directors of ABC Company and XYZ Corporation and should not be used by those who have not agreed to the procedures and taken responsibility for the sufficiency of the procedures for their purposes.

[As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4.] (See section 600.)

## 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 cash flows 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<sup>30</sup> 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 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.

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<sup>30</sup> 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 the issuance of Statement on Auditing Standards No. 72, February 1993. Footnote subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 4, September 1995.]

.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 discussing 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.

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## Appendix A\*

### Minimum Presentation Guidelines

1. Prospective information presented in the format of historical financial statements facilitates comparisons with financial position, results of operations, and cash flows 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<sup>1</sup> or may be limited to the following minimum items (where such items would be presented for historical financial statements for the period).<sup>2</sup>

- 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<sup>3</sup>
- 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.<sup>4</sup> A presentation that contains the applicable minimum items a through i above, but omits minimum items j through l above is not a partial presentation, and an engagement involving such a presentation is subject to the provisions of this section.

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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 Information*. Complete presentation guidelines for entities that choose to issue prospective financial statements, together with illustrative presentations, are included in the guide.

<sup>1</sup> 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.

<sup>2</sup> 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.

<sup>3</sup> 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 Information*.

<sup>4</sup> Footnote deleted.

## Appendix B

# 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 Information*.
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 regarding the services to be performed. The understanding should include the objectives of the engagement, the client's responsibilities, the accountant's responsibilities, and limitations of the engagement. The accountant should document the understanding in the working papers, preferably through a written communication with the client. If the accountant believes an understanding with the client has not been established, he or she should decline to accept or perform the engagement.
  - 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.<sup>1</sup>
  - 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 cash flows for the forecast period and that

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<sup>1</sup> Presentation guidelines for entities that issue prospective financial statements are set forth and illustrated in the AICPA *Guide for Prospective Financial Information*.

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 position, results of operations, and cash flows 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.<sup>2</sup> (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.)

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<sup>2</sup> 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

# 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 Information*.
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<sup>1</sup> 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.

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<sup>1</sup> *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.

- c. Factors specific to the industry, including competitive conditions, sensitivity to economic conditions, accounting policies, specific regulatory requirements, and technology.
- 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 should establish an understanding with the responsible party regarding the services to be performed. The understanding should include the objectives of the engagement, the responsible party's responsibilities, the accountant's responsibilities, and limitations of the engagement. The accountant should document the understanding in the working papers, preferably through a written communication with the responsible party. If the accountant believes an understanding with the responsible party has not been established, he or she should decline to accept or perform the engagement. If the responsible party is different than the client, the accountant should establish the understanding with both the client and the responsible party, and the understanding also should include the client's responsibilities.

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 cash flows for the prospective period<sup>2</sup> 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<sup>3</sup> and (ii) that the assumptions are suitably supported.
- 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 cash flows for the prospective period given the hypothetical assumptions<sup>4</sup> 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.

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<sup>2</sup> 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.

<sup>3</sup> 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.

<sup>4</sup> 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.

- 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 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.<sup>5</sup>
  - 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.<sup>6</sup>
  - e. Presentation of the prospective financial statements follows the AICPA guidelines applicable for such statements.<sup>7</sup>
  - f. Assumptions have been adequately disclosed based on AICPA presentation guidelines for prospective financial statements.

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<sup>5</sup> 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.]

<sup>6</sup> 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.

<sup>7</sup> Presentation guidelines for entities that issue prospective financial statements are set forth and illustrated in the AICPA *Guide for Prospective Financial Information*.

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, subparagraph 5*i* describes the specific representations to be obtained for a financial forecast and a financial projection.

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[The next page is 2701.]

## AT Section 300

# Reporting on Pro Forma Financial Information

Source: SSAE No. 1; SAS No. 76.

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 section 100, *Attestation Standards*, and the specific performance and reporting standards set forth in this statement.<sup>1</sup>

.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).<sup>2</sup>

## 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.

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<sup>1</sup> AU section 634, *Letters for Underwriters and Certain Other Requesting Parties*, identifies, in paragraphs .03 through .05, certain parties who may request a letter. When one of those parties requests a letter or asks the accountant to perform agreed-upon procedures on pro forma financial information in connection with an offering, the accountant should follow the guidance in AU section 634 (see paragraphs .03 through .10, .36, .42, and .43). [As amended, effective for letters issued pursuant to AU section 634.09 after April 30, 1996, by Statement on Auditing Standards No. 76.] (See AU section 634.)

<sup>2</sup> 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 .28.

- Disposition of a significant portion of business.
- 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.<sup>3</sup>

## 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).<sup>4</sup> 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.<sup>5</sup> 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

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<sup>3</sup> 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.

<sup>4</sup> 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.

<sup>5</sup> 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.

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 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,<sup>6</sup> 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 adjustments

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<sup>6</sup> See paragraph .07(b).

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.<sup>7</sup> 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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<sup>7</sup> See paragraph 66 of the SSAE, *Attestation Standards* [section 100.67].

## Examples of Reports on Pro Forma Financial Information

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### Appendix A

#### 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*]<sup>8</sup> 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,<sup>9</sup> appearing elsewhere herein [*or incorporated by reference*].<sup>10</sup> 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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<sup>8</sup> 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.

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

<sup>10</sup> If the option in footnote 4 to paragraph .07a is followed, the report should be appropriately modified.

## Appendix B

### 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]<sup>11</sup> 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,<sup>12, 13</sup> appearing elsewhere herein [or incorporated by reference].<sup>14</sup> 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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<sup>11</sup> 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.

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

<sup>13</sup> 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].

<sup>14</sup> If the option in footnote 4 to paragraph .07a is followed, the report should be appropriately modified.

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## Appendix C

### 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]<sup>15</sup> 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,<sup>16</sup> appearing elsewhere herein [or incorporated by reference].<sup>17</sup> 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]<sup>15</sup> 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,<sup>18</sup> appearing elsewhere herein [or incorporated by reference].<sup>17</sup> 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

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<sup>15</sup> 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.

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

<sup>17</sup> If the option in footnote 4 to paragraph .07a is followed, the report should be appropriately modified.

<sup>18</sup> 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].

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.

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 balance sheet as of March 31, 19X2, and the pro forma condensed statement of income for the three months then ended.

## Appendix D

### 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,<sup>19</sup> and of Y Company, which were audited by other accountants, appearing elsewhere herein [or incorporated by reference].<sup>20</sup> 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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<sup>19</sup> If either accountant's report includes an explanatory paragraph or is other than unqualified, that fact should be referred to within this report.

<sup>20</sup> If the option in footnote 4 to paragraph .07a is followed, the report should be appropriately modified.



## Appendix E

### 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]<sup>21</sup> 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,<sup>22</sup> appearing elsewhere herein [or incorporated by reference].<sup>23</sup> 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

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<sup>21</sup> 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.

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

<sup>23</sup> If the option in footnote 4 to paragraph .07a is followed, the report should be appropriately modified.

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:

*[Same first and second paragraphs as 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]*<sup>24</sup> 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,<sup>25</sup> and of Y Company which were audited by other accountants, appearing elsewhere herein *[or incorporated by reference]*.<sup>26</sup> 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.

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[The next page is 2731.]

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<sup>24</sup> See footnote 21.

<sup>25</sup> See footnote 22.

<sup>26</sup> See footnote 23.

## AT Section 400

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

(Supersedes AU section 642)

Source: SSAE No. 2; SSAE No. 4; SSAE No. 6; SSAE No. 9.

See section 9400 for interpretations of this section.

Effective for an examination of management's assertion on the effectiveness of an entity's internal control over financial reporting when the assertion is as of December 15, 1993 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. This section, therefore, becomes SSAE No. 2, Reporting on an Entity's Internal Control Over Financial Reporting.*

## Applicability

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

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

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<sup>1</sup> This section does not change the auditor's responsibility for considering the entity's internal control in an audit of the financial statements. See paragraphs .82 through .85.

<sup>2</sup> Ordinarily, the practitioner will be engaged to examine management's assertion about the effectiveness of the entity's internal control 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 management's assertion about the effectiveness of an entity's internal control during a period of time. In that case, the guidance in this section should be modified accordingly. [As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

- b. Engagements to examine management's assertion about the design and operating effectiveness of an entity's internal control (paragraphs .15 through .69)
- c. Engagements to examine management's assertion about the design and operating effectiveness of a segment of an entity's internal control (paragraph .70)
- d. Engagements to examine management's assertion about only the suitability of design of an entity's internal control (no assertion is made about the operating effectiveness of the internal control) (paragraphs .71 and .72)
- e. Engagements to examine management's assertion about the design and operating effectiveness of an entity's internal control based on criteria established by a regulatory agency (paragraphs .73 through .77)

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

- a. Engagements to examine management's assertion about controls over operations or compliance with laws and regulations<sup>3</sup>
- b. Agreed-upon procedures engagements (except as noted in paragraph .05)
- c. Certain other services in connection with an entity's internal control covered by other authoritative guidance (paragraph .07 and the appendix [paragraph .88])
- d. Consulting engagements (paragraph .08)
- e. Engagements to gather data for management (paragraphs .11 and .20)

[As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.02 An entity's internal control over financial reporting<sup>4</sup> 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 management's assertion about the effectiveness of an entity's internal control should comply with the general, fieldwork, and reporting standards in section 100, and the specific performance and reporting standards set forth in this section.<sup>5</sup> [As amended, effective for reports

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<sup>3</sup> A practitioner engaged to examine management's assertion about the effectiveness of an entity's internal control over operations or compliance with laws and regulations should refer to the guidance in section 100, *Attestation Standards*. A practitioner engaged to perform agreed-upon procedures on management's assertion relating to an entity's internal control over operations or compliance with laws and regulations should refer to the guidance in section 600, *Agreed-Upon Procedures Engagements*. In addition, the guidance in section 500, *Compliance Attestation*, may be helpful when performing an engagement relating to internal control over compliance with laws and regulations. Further, the guidance in this section may be helpful in attestation engagements to report on management's assertion about internal control over operations or compliance with laws and regulations. [As amended, effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, by Statement on Standards for Attestation Engagements No. 6.]

<sup>4</sup> Throughout this section, an entity's internal control over financial reporting<sup>4</sup> is referred to as its *internal control*.

<sup>5</sup> Practitioners engaged to examine and report on the design and/or operating effectiveness of the internal control of a service organization should refer to AU section 324, *Service Organizations*.

on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

**.03** Management may present its written assertion about the effectiveness of the entity's internal control in either of two forms:

- a. A separate report that will accompany the practitioner's report
- b. A representation letter to the practitioner

If management's assertion does not accompany the practitioner's report, the first paragraph of the report should also contain a statement of management's assertion. [As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

**.04** Management's written assertion about the effectiveness of an entity's internal control may take various forms. Throughout this section, for example, the phrase, "management's assertion that W Company maintained effective internal control over financial reporting as of [date]," illustrates such an assertion. Other phrases, such as "management's assertion that W Company's internal control 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, "very effective" internal control) 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. 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. For such engagements, the practitioner should refer to the guidance in section 600, *Agreed-Upon Procedures Engagements*. However, notwithstanding the guidance set forth in section 600, a practitioner's report on agreed-upon procedures related to management's assertion about the effectiveness of the entity's internal control should be in the form of procedures and findings. The practitioner should not provide negative assurance about whether management's assertion is fairly stated. [As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

**.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, he or she should not accept an engagement to *review* such a management assertion. [As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

**.07** The appendix [paragraph .88] presents a listing of authoritative guidance for a practitioner engaged to provide other services in connection with an entity's internal control. Under the Securities Exchange Act of 1934, certain reports on the entity's internal control are required. Rule 17a-5 requires such a report for a broker or dealer in securities. The American Institute of Certified

Public Accountants (AICPA) *Audit and Accounting Guide 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 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 .88] to this section, in Rule 17a-5, and in Form N-SAR, is not covered by this section.

## Nonattest Services

.08 The guidance in this section does not apply if management does not provide the practitioner with a written assertion. However, management may engage the practitioner to provide certain nonattest services in connection with the entity's internal control. For example, management may engage the practitioner to provide recommendations on improvements to the entity's internal control. A practitioner engaged to provide such nonattest services should refer to the guidance in the *Statement on Standards for Consulting Services (SSCS) No. 1, Consulting Services: Definitions and Standards* [CS section 100]. [As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by *Statement on Standards for Attestation Engagements No. 9*.]

[.09] [Superseded by *Statement on Standards for Attestation Engagements No. 4*, effective for reports on agreed-upon procedures engagements dated after April 30, 1996.] (See section 600.)

## Conditions for Engagement Performance

.10 A practitioner may *examine* management's assertion about the effectiveness of an entity's internal control if the following conditions are met:

- a. Management accepts responsibility for the effectiveness of the entity's internal control.
- b. Management evaluates the effectiveness of the entity's internal control using reasonable criteria for effective internal control established by a recognized body. Such criteria are referred to as *control criteria* throughout this section.<sup>6</sup>

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<sup>6</sup> 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.

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 100.18. If the practitioner determines that such criteria are reasonable for general distribution reporting, such criteria should be stated in 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.

[As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by *Statement on Standards for Attestation Engagements No. 9*.]

- c. Sufficient evidential matter exists or could be developed to support management's evaluation.
- d. Management provides to the practitioner its written assertion about the effectiveness of the entity's internal control based on the control criteria referred to in its report.

[As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.11 Management is responsible for establishing and maintaining effective internal control. In some cases, management may evaluate and report on the effectiveness of internal control 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.

## Components of an Entity's Internal Control

.12 The components that constitute an entity's internal control are a function of the definition and description of internal control selected by management for the purpose of assessing its effectiveness. For example, management may select the definition and description of internal control based on the internal control framework set forth in *Internal Control—Integrated Framework*,<sup>7</sup> published by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission.<sup>8</sup> *Internal Control—Integrated Framework* describes an entity's internal control as consisting of five components: control environment, risk assessment, control activities, information and communication, and monitoring. If management selects another definition and description of internal control, these components may not be relevant. [As amended, effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, by Statement on Standards for Attestation Engagements No. 6.]

Former paragraphs .13 through .16 have been deleted and all subsequent paragraphs renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter.

## Limitations of an Entity's Internal Control

.13 Internal control, no matter how well designed and operated, can provide only reasonable assurance to management and the board of directors

<sup>7</sup> As noted in footnote 6, this report also contains control criteria. [Footnote added, effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, by Statement on Standards for Attestation Engagements No. 6.]

<sup>8</sup> This definition and description is consistent with the definition contained in AU section 319, *Consideration of Internal Control in a Financial Statement Audit*. However, AU section 319 is not intended to provide criteria for evaluating internal control effectiveness. [Footnote added, effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, by Statement on Standards for Attestation Engagements No. 6.]

regarding achievement of an entity's control objectives. The likelihood of achievement is affected by limitations inherent to internal control. These include the realities that human judgment in decision-making can be faulty, and that breakdowns in internal control can occur because of such human failures as simple error or mistake. Additionally, controls can be circumvented by the collusion of two or more people or management override of internal control. [Paragraph renumbered and amended, effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, by Statement on Standards for Attestation Engagements No. 6.]

.14 Custom, culture, and the corporate governance system may inhibit fraud by management, but they are not absolute deterrents. An effective control environment, too, may help mitigate the probability of such fraud. For example, an effective board of directors, audit committee, and an internal audit function may constrain improper conduct by management. Alternatively, an ineffective control environment may negate the effectiveness of the other components. For example, when the presence of management incentives creates an environment that could result in material misstatement of financial statements, the effectiveness of control activities may be reduced. The effectiveness of an entity's internal control 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. [Paragraph renumbered and amended, effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, by Statement on Standards for Attestation Engagements No. 6. As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## Examination Engagement

.15 The practitioner's objective in an engagement to examine management's assertion about the effectiveness of the entity's internal control is to express an opinion on (a) the effectiveness of the entity's internal control, in all material respects, based on the control criteria or (b) whether management's assertion about the effectiveness of internal control is fairly stated, in all material respects, based on the control criteria. The practitioner's opinion relates to the effectiveness of the entity's internal control taken as a whole, and not to the effectiveness of each individual component (control environment, risk assessment, control activities, information and communication, and monitoring) of the entity's internal control.<sup>9</sup> Therefore, the practitioner considers the interrelationship of the components of an entity's internal control in achieving the objectives of the control criteria. To express an opinion, the practitioner accumulates sufficient evidence about the design effectiveness and operating effectiveness of the entity's internal control, thereby limiting attestation risk to an appropriately low level. When evaluating the design effectiveness of specific controls, the practitioner considers whether the control is suitably designed to prevent or detect material misstatements on a timely basis. When evaluating operating effectiveness, the practitioner considers how

<sup>9</sup> However, as discussed in paragraph .70, management's assertion may relate to a segment of its internal control. [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995.]



the control was applied, the consistency with which it was applied, and by whom it was applied. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

**.16** Performing an examination of management's assertion about the effectiveness of an entity's internal control involves (a) planning the engagement, (b) obtaining an understanding of internal control, (c) evaluating the design effectiveness of the controls, (d) testing and evaluating the operating effectiveness of the controls and (e) forming an opinion on the effectiveness of the entity's internal control, or management's assertion thereon, based on the control criteria. [Paragraph renumbered and amended, effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, by Statement on Standards for Attestation Engagements No. 6. As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## Planning the Engagement

### *General Considerations*

**.17** Planning an engagement to examine management's assertion about the effectiveness of the entity's internal control 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 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
- Management's method of evaluating the effectiveness of the entity's internal control 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
- The nature of specific controls designed to achieve the objectives of the control criteria, and their significance to internal control taken as a whole
- Preliminary judgments about the effectiveness of internal control

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. As amended, effective for reports on

the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

### **Multiple Locations**

.18 A practitioner planning an engagement to examine management's assertion on the effectiveness of the internal control 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 .17, the selection of locations should be based on factors such as (a) the similarity of business operations and internal control at the various locations, (b) the degree of centralization of records, (c) the effectiveness of the control environment, particularly 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

### **Internal Audit Function**

.19 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 controls. The results of these tests are often an important basis for management's assertions about the effectiveness of the entity's internal control. 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995.]

### **Documentation**

.20 Controls and the control objectives that they were designed to achieve should be appropriately documented to serve as a basis for management's assertion and the practitioner's report. 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## Obtaining an Understanding of Internal Control

.21 A practitioner generally obtains an understanding of the design of specific controls 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 paragraph .17. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995.]

## Evaluating the Design Effectiveness of Controls

.22 To evaluate the design effectiveness of an entity's internal control, the practitioner should obtain an understanding of the controls within each component of internal control.<sup>10</sup> [Paragraph renumbered and amended, effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, by Statement on Standards for Attestation Engagements No. 6.]

Former paragraph .27 has been deleted and all subsequent paragraphs renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter.

.23 Any of the components of internal control may include controls designed to achieve the objectives of the control criteria. Some controls 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 controls are designed to achieve specific objectives of the control criteria. For example, management generally establishes specific controls, such as accounting for all shipping documents, to ensure that all valid sales are recorded. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.24 The practitioner should focus on the significance of controls in achieving the objectives of the control criteria rather than on specific controls in isolation.

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<sup>10</sup> As discussed in paragraph .12, the components that constitute an entity's internal control are a function of the definition and description of internal control selected by management. Paragraph .12 lists the components the practitioner should understand if management decides to evaluate the entity's internal control based on the definition of internal control in *Internal Control—Integrated Framework*. If management selects another definition, these components may not be relevant. [Footnote added, effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, by Statement on Standards for Attestation Engagements No. 6. As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

The absence or inadequacy of a specific control designed to achieve the objectives of a specific criterion may not be a deficiency if other controls specifically address the same criterion. Further, when one or more control achieves the objectives of a specific criterion, the practitioner may not need to consider other controls designed to achieve those same objectives. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995.]

.25 Procedures to evaluate the effectiveness of the design of a specific control are concerned with whether that control 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 control, the nature of the entity's documentation of the specific control, and the complexity and sophistication of the entity's operations and systems. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995.]

### Testing and Evaluating the Operating Effectiveness of Controls

.26 To evaluate the operating effectiveness of an entity's internal control, the practitioner performs tests of relevant controls to obtain sufficient evidence to support the opinion in the report. Tests of the operating effectiveness of a control are concerned with how the control 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 control. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995.]

.27 The evidential matter that is sufficient to support a practitioner's opinion is a matter of professional judgment. However, the practitioner should consider matters such as the following:

- The nature of the control
- The significance of the control in achieving the objectives of the control criteria
- The nature and extent of tests of the operating effectiveness of the controls performed by the entity, if any
- The risk of noncompliance with the control, 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, the control environment 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
  - Whether more than one control achieves a specific objective

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

**.28** Management or other entity personnel may provide the practitioner with the results of their tests of the operating effectiveness of certain controls. Although the practitioner should consider the results of such tests when evaluating the operating effectiveness of controls, 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995.]

**.29** The nature of the controls influences the nature of the tests of controls the practitioner can perform. For example, the practitioner may examine documents regarding controls for which documentary evidence exists. However, documentary evidence regarding the control environment (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 the control environment often influence the nature, timing, and extent of the tests of controls to be performed to obtain evidence about the operating effectiveness of controls in the accounting system and other controls. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995.]

**.30** 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 controls being tested and with the frequency with which specific controls operate and specific policies are applied. Some controls 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 controls necessary for achieving the objectives of the control criteria are operating effectively. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995.]

**.31** Management may request the practitioner to examine management's assertion about the effectiveness of controls related to the preparation of interim financial information. Depending on the period(s) selected by management, the practitioner should perform tests of controls in effect during one or more interim periods to form an opinion about the effectiveness of such controls in achieving the related interim reporting objectives. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No.

6, December 1995. As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.32 Prior to the date as of which management's assertion about internal control over financial reporting is made, management may change the entity's controls to make them more effective or efficient, or to address control deficiencies. In these circumstances, the practitioner may not need to consider controls that have been superseded. For example, if the practitioner determines that the new controls 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 controls. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

### Forming an Opinion

.33 When forming an opinion on the effectiveness of an entity's internal control or management's assertion thereon, 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 controls based on the control criteria. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## Deficiencies in an Entity's Internal Control

.34 During the course of the engagement, the practitioner may become aware of significant deficiencies in the entity's internal control. The practitioner's responsibility to communicate such deficiencies is described in paragraphs .40 and .41. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995.]

### Reportable Conditions

.35 AU section 325, *Communication of Internal Control 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 internal control 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995.]

### Material Weaknesses

.36 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 com-

ponents does not reduce to a relatively low level the risk that misstatements caused by error or fraud 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 the practitioner from concluding that the entity has effective internal control. However, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the practitioner may qualify his or her opinion (that is, express an opinion that internal control is effective "except for" the material weakness noted) or may express an adverse opinion.<sup>11</sup> [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

**.37** When evaluating whether a reportable condition is also a material weakness, the practitioner should recognize that—

- a. The amounts of misstatements caused by error or fraud 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 misstatement due to error or fraud is likely to be different for the different possible amounts within that range. For example, the risk of misstatement due to error or fraud in amounts equal to the gross exposure might be very low, but the risk of smaller amounts might be progressively greater.

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995.]

**.38** 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 misstatement caused by error or fraud 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 misstatements would be material.

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995.]

**.39** 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 controls, and the judgment of those making the evaluation. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995.]

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<sup>11</sup> Paragraphs .52 through .59 contain guidance the practitioner should consider when a material weakness exists. [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## Communicating Reportable Conditions and Material Weaknesses

.40 A practitioner engaged to examine management's assertion about the effectiveness of the entity's internal control should communicate reportable conditions to the audit committee<sup>12</sup> 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.41 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995.]

## Management's Representations

.42 The practitioner should obtain written representations from management—<sup>13</sup>

- a. Acknowledging management's responsibility for establishing and maintaining internal control.
- b. Stating that management has performed an evaluation of the effectiveness of the entity's internal control and specifying the control criteria used.
- c. Stating management's assertion about the effectiveness of the entity's internal control based on the control criteria as of a specified date.
- d. Stating that management has disclosed to the practitioner all significant deficiencies in the design or operation of internal control 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 internal control.
- e. Describing any material fraud and any other fraud that, although not material, involve management or other employees who have a significant role in the entity's internal control.

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<sup>12</sup> 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. [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995.]

<sup>13</sup> AU section 333, *Management Representations*, provides guidance on the date as of which management should sign such a representation letter and which member(s) of management should sign it. [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]



- f. Stating whether there were, subsequent to the date being reported on, any changes in internal control or other factors that might significantly affect internal control, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.43 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. Further, the practitioner should consider the effects of management's refusal on his or her ability to rely on other management representations. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995.]

## Reporting Standards

[.44] [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph deleted by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.45 The practitioner's report should include the following:

- a. A title that includes the word *independent*
- b. An identification of management's assertion about the effectiveness of the entity's internal control over financial reporting as of a specified date (When management's assertion does not accompany the practitioner's report, the first paragraph of the report should also contain a statement of management's assertion.)
- c. A statement that the assertion is the responsibility of management
- d. A statement that the practitioner's responsibility is to express an opinion on [*the effectiveness of an entity's internal control or management's assertion*] based on his or her examination
- e. A statement that the examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing other such procedures as the practitioner considered necessary in the circumstances
- f. A statement that the practitioner believes the examination provides a reasonable basis for his or her opinion
- g. A paragraph stating that, because of inherent limitations of any internal control, misstatements due to errors or fraud may occur and not be detected (In addition, the paragraph should state that projections

of any evaluation of internal control over financial reporting to future periods are subject to the risk that internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.)

- h. The practitioner's opinion on whether (1) the entity has maintained, in all material respects, effective internal control over financial reporting as of the specified date based on the control criteria or (2) management's assertion about the effectiveness of the entity's internal control over financial reporting as of the specified date is fairly stated, in all material respects, based on the control criteria<sup>14</sup>
- i. If the assertion has been prepared in conformity with criteria specified by a regulatory agency (see paragraph .73) or that have been agreed upon by the asserter and the specified parties, the practitioner's report should also contain—
  - A statement of limitations on the use of the report because it is intended solely for specified parties (see the fourth reporting standard)
  - A statement, when established criteria exist, that the assertion is not intended to be that which would have been presented if the assertion were presented based on *[identify established criteria]*
- j. The manual or printed signature of the practitioner's firm
- k. The date of the examination report

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.46 The following is the form of report a practitioner should use when he or she expresses an opinion directly on the effectiveness of an entity's internal control as of a specified date.

#### Independent Accountant's Report

##### *[Introductory paragraph]*

We have examined management's assertion included in the accompanying *[title of management report]*, that W Company maintained effective internal control over financial reporting as of December 31, 19XX based on *[identify stated or established criteria]*.<sup>15</sup> Management is responsible for maintaining effective

<sup>14</sup> See paragraph .52 for reporting when the examination discloses conditions that, individually or in combination, result in one or more material weaknesses. [Footnote added, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

<sup>15</sup> 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 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. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying *[title of management report]*" would be omitted. [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Footnote subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

[*Scope paragraph*]

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, testing, and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Inherent limitations paragraph*]

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that internal control 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, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 19XX, based on [*identify stated or established criteria*].<sup>16</sup>

[*Signature*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. As amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.47 The following is the form of report a practitioner should use when he or she expresses an opinion on management's assertion about the effectiveness of an entity's internal control as of a specified date.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion, included in the accompanying [*title of management report*], that W Company maintained effective internal control over financial reporting as of December 31, 19XX, based on [*identify stated or established criteria*].<sup>17</sup> Management is responsible for maintaining

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<sup>16</sup> For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)." [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Footnote subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

<sup>17</sup> 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 as management uses in its report, including the kinds of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying [*title of management report*]" would be omitted. [Footnote added, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

effective internal control over financial reporting. Our responsibility is to express an opinion on management's assertion based on our examination.

*[Standard scope and inherent limitations paragraphs]*

*[Opinion paragraph]*

In our opinion, management's assertion that W Company maintained effective internal control over financial reporting as of December 31, 19XX is fairly stated, in all material respects, based on *[identify stated or established criteria]*.<sup>18</sup>

*[Signature]*

*[Date]*

[Paragraph added, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

### Management's Assertion Presented Only in a Letter of Representation to the Practitioner

[.48-.50] [Paragraphs renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraphs subsequently renumbered and deleted by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]<sup>[19]</sup>

### Report Modifications

.51 The practitioner should modify the standard reports if any of the following conditions exist:

- a. There is a material weakness in the entity's internal control (paragraphs .52 through .59).
- b. There is a restriction on the scope of the engagement (paragraphs .60 through .63).
- c. The practitioner decides to refer to the report of another practitioner as the basis, in part, for the practitioner's own report (paragraphs .64 and .65).
- d. A significant subsequent event has occurred since the date being reported on (paragraphs .66 through .69).
- e. Management's assertion relates to the effectiveness of only a segment of the entity's internal control (paragraph .70).
- f. Management's assertion only relates to the suitability of design of the entity's internal control (paragraphs .71 and .72).
- g. Management's assertion is based upon criteria established by a regulatory agency without following due process (paragraphs .73 through .77).

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered

<sup>18</sup> For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)." [Footnote added, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

<sup>[19]</sup> [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Footnote subsequently renumbered and deleted by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## Material Weaknesses

.52 If the examination discloses conditions that, individually or in combination, result in one or more material weaknesses (paragraphs .36 through .39), the practitioner should modify the report and, to most effectively communicate with the reader of the report, should express his or her opinion directly on the effectiveness of internal control, not on management's assertion. 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

### *Management Includes the Material Weakness in Its Assertion*

.53 If management includes in its representation to the practitioner and 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 in light of that weakness, the practitioner should both modify the opinion paragraph by including a reference to the material weakness and add an explanatory paragraph (preceding the opinion paragraph) that describes the weakness.<sup>20</sup> [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.54 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 in light of that weakness.<sup>[21]</sup>

#### Independent Accountant's Report

##### *[Introductory paragraph]*

We have examined management's assertion, included in the accompanying *[title of management report]* that, except for the material weakness described

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<sup>20</sup> As stated in paragraph .36, the existence of a material weakness precludes the practitioner from concluding that an entity's internal control is effective. [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Footnote subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

<sup>[21]</sup> [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Footnote subsequently renumbered and deleted by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

below, W Company has maintained effective internal control over financial reporting as of December 31, 19XX, based on *[identify stated or established criteria]*.<sup>22</sup> Management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

*[Standard scope and inherent limitations paragraphs]*

*[Explanatory paragraph]*

*[Include sentence(s) describing the material weakness and its effect on the achievement of the objectives of the control criteria and a statement that the condition represents a material weakness.]* A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis.<sup>23</sup>

*[Opinion paragraph]*

In our opinion, except for the effect of the material weakness described in the preceding paragraph on the achievement of the objectives of the control criteria, W Company has maintained, in all material respects, effective internal control over financial reporting as of December 31, 19XX, based on *[identify established or stated criteria]*.

*[Signature]*

*[Date]*

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.55 The following is the form of report, expressing an adverse opinion, that a practitioner should use when management includes in its assertion to the practitioner 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 in light of that weakness. An adverse opinion is expressed when, in the practitioner's judgment, the material weakness(es) is (are) so pervasive that the entity's internal control over financial reporting does not achieve the control objectives.

<sup>22</sup> 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 as management uses in its report, including the kinds of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying *[title of management report]*" would be omitted. [Footnote added, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

<sup>23</sup> This description of a material weakness differs from the definition of material weakness discussed in paragraph .36. Although a practitioner should consider the definition contained in paragraph .36 when determining whether a material weakness exists, the description above should be used to describe a material weakness in the practitioner's report. [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Footnote subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

Independent Accountant's Report*[Introductory paragraph]*

We have examined management's assertion, included in the accompanying [title of management report], that, because of the effect of the material weakness described below, W Company has not maintained effective internal control over financial reporting as of December 31, 19XX, based on [identify stated or established criteria].<sup>24</sup> Management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

*[Standard scope and inherent limitations paragraphs]**[Explanatory paragraph]*

[Include sentence(s) describing the material weakness and its effect on the achievement of the objectives of the control criteria and a statement that the condition represents a material weakness.] A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis.<sup>25</sup>

*[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, W Company has not maintained effective internal control over financial reporting as of December 31, 19XX, based on [identify established or stated criteria].

*[Signature]*

*[Date]*

[Paragraph added, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

**Disagreements With Management**

.56 In some circumstances, management may disagree with the practitioner over the existence of a material weakness and, therefore, not include in its assertion an appropriate description of such a weakness and its effect on the achievement of the objectives of the control criteria. In other circumstances,

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<sup>24</sup> 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 as management uses in its report, including the kinds of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying [title of management report]" would be omitted. [Footnote added, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

<sup>25</sup> This description of a material weakness differs from the definition of material weakness discussed in paragraph .36. Although a practitioner should consider the definition contained in paragraph .36 when determining whether a material weakness exists, the description above should be used to describe a material weakness in the practitioner's report. [Footnote added, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

management may describe a material weakness but nevertheless assert that the entity's internal control is effective.<sup>[26]</sup> In such cases, the practitioner should modify his or her report; an example of an adverse opinion in such a situation is given in paragraph .57. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.57 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

*[Introductory paragraph]*

We have examined management's assertion, included in the accompanying *[title of management report]* that, except for the material weakness described below, W Company has maintained effective internal control over financial reporting as of December 31, 19XX, based on *[identify stated or established criteria]*.<sup>27</sup> Management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

*[Standard 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 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 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, W Company did not maintain effective internal control over financial reporting as of December 31, 19XX, based on *[identify established or stated criteria]*.

*[Signature]*

*[Date]*

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<sup>[26]</sup> [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Footnote subsequently renumbered and deleted by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

<sup>27</sup> 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 as management uses in its report, including the kinds of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying *[title of management report]*" would be omitted. [Footnote added, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]



[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.58 If management's assertion accompanying the practitioner's report contains a statement that management believes the cost of correcting the weakness would exceed the benefits to be derived from implementing new controls, 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 .79 and .80 and take appropriate action. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

### ***Practitioner's Report on Internal Control Identifies a Material Weakness and Is Included in the Same Document Containing the Audit Report***

.59 If the practitioner's report on his or her examination of management's assertion about the effectiveness of the entity's internal control is included 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

### **Scope Limitations**

.60 An unqualified opinion on the effectiveness of the entity's internal control or management's assertion thereon 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 the effectiveness of the entity's internal control. [Paragraph renumbered by the issuance of *Statement on Standards for Attestation Engagements No. 6*, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by *Statement on Standards for Attestation Engagements No. 9*.]

.61 For example, management may have implemented controls to correct a material weakness identified prior to the date of management's assertion. However, unless the practitioner has been able to obtain evidence that the new controls were appropriately designed and have been operating effectively for a sufficient period of time,<sup>28</sup> he or she should refer to the material weakness 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 conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, testing, and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

*[Explanatory paragraph]*

Our examination disclosed the following material weaknesses in the design or operation of internal control of W Company in effect at [date]. A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis. 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.

*[Standard inherent limitations paragraph]*

*[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

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<sup>28</sup> See guidance in paragraph .30. [Footnote renumbered by the issuance of *Statement on Standards for Attestation Engagements No. 6*, December 1995. Footnote subsequently renumbered by the issuance of *Statement on Standards for Attestation Engagements No. 9*, January 1999.]

system, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 19XX based on *[identify established or stated criteria]*.

*[Signature]*

*[Date]*

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.62 When restrictions that significantly limit the scope of the examination are imposed by the client, the practitioner generally should disclaim an opinion on the effectiveness of the entity's internal control or on management's assertion thereon. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.63 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, included in the accompanying *[title of management's report]*, that W Company maintained effective internal control over financial reporting as of December 31, 19XX, based on *[identify stated or established criteria]*.<sup>29</sup> Management is responsible for maintaining effective internal control over financial reporting.

*[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 the entity's internal control over financial reporting, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the effectiveness of the entity's internal control over financial reporting.

*[Signature]*

*[Date]*

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<sup>29</sup> 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 as management uses in its report, including the kinds of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying *[title of management report]*" would be omitted. [Footnote added, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

### Opinion Based in Part on the Report of Another Practitioner

.64 When another practitioner has examined management's assertion about the effectiveness of internal control 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. 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*, 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.65 When the practitioner decides to make reference to the report of the other practitioner as a basis, in part, for the practitioner's opinion, 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.<sup>30</sup> The following form of the report is appropriate in these circumstances.

#### Independent Accountant's Report

##### *[Introductory paragraph]*

We have examined management's assertion, included in the accompanying *[title of management's report]*, that W Company maintained effective internal control over financial reporting as of December 31, 19XX based on *[identify established or stated criteria]*.<sup>31</sup> Management is responsible for maintaining

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<sup>30</sup> Whether the other practitioner's opinion is expressed on management's assertion or on the effectiveness of internal control does not affect the determination of whether the principal practitioner's opinion is expressed on the assertion or on the subject matter itself. [Footnote added, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

<sup>31</sup> 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 as management uses in its report, including the kinds of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying *[title of management report]*" would be omitted. [Footnote added, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination. We did not examine management's assertion about the effectiveness of internal control 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 over financial reporting was examined by other accountants whose report has been furnished to us, and our opinion, insofar as it relates to the effectiveness of B Company's internal control over financial reporting, is based solely on the report of the other accountants.

[*Scope paragraph*]

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, testing, and evaluating the design and operating effectiveness of internal control, and performing 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, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 19XX, based on [*identify established or stated criteria*].

[*Signature*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## Subsequent Events

.66 Changes in internal control or other factors that might significantly affect internal control may occur subsequent to the date as of which the internal control over financial reporting is being examined but before the date of the practitioner's report. As described in paragraph .42, the practitioner should obtain management's representations relating to such matters. Additionally, to obtain information about whether changes have occurred that might affect the effectiveness of the entity's internal control 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

- d. Information about the effectiveness of the entity's internal control obtained through other professional engagements

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.67 If the practitioner obtains knowledge about subsequent events that he or she believes significantly affect the effectiveness of the entity's internal control as of the date of management's assertion, the practitioner should report directly on the effectiveness of the entity's internal control, and issue a qualified or an adverse opinion. If the practitioner is unable to determine the effect of the subsequent event on the effectiveness of the entity's internal control, the practitioner should disclaim an opinion. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.68 The practitioner may obtain knowledge about subsequent events with respect to conditions that did not exist at the date of management's assertion but arose subsequent to that date. Occasionally, a subsequent event of this type has such a material impact on the entity that the practitioner may wish to include in his or her report an explanatory paragraph describing the event and its effects or directing the reader's attention to the event and its effects. [Paragraph added; effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.69 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 the practitioner's report on the effectiveness of the entity's internal control. Based on these considerations, detailed guidance is provided for the auditor in AU section 561.06. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

### **Reporting on the Effectiveness of a Segment of the Entity's Internal Control**

.70 When engaged to examine management's assertion on the effectiveness of only a segment of an entity's internal control (for example, internal

control 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 .45 through .63, modified to refer to the segment of the entity's internal control 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, included in the accompanying *[title of management report]*, that W Company's retail division maintained effective internal control over financial reporting as of December 31, 19XX, based on *[identify stated or established criteria]*.<sup>32</sup> Management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

*[Standard scope and inherent limitations paragraphs]*

*[Opinion paragraph]*

In our opinion, W Company's retail division maintained, in all material respects, effective internal control over financial reporting as of December 31, 19XX based on *[identify established or stated criteria]*.

*[Signature]*

*[Date]*

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## Reporting on the Suitability of Design of the Entity's Internal Control

.71 Management may request the practitioner to examine an assertion about the suitability of the design of the entity's internal control for preventing or detecting material misstatements on a timely basis. For example, prior to granting a new casino a license to operate, a regulatory agency may request a report on whether the internal control 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 for the regulatory agency's purpose,

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<sup>32</sup> 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 as management uses in its report, including the kinds of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying *[title of management report]*" would be omitted. [Footnote added, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

the practitioner should obtain an understanding of the components of internal control<sup>33</sup> that management should implement to meet the control objectives of the regulatory agency and identify the controls that are relevant to those control objectives. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.72 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.<sup>34</sup>

#### Independent Accountant's Report

##### *[Introductory paragraph]*

We have examined management's assertion, included in the accompanying *[title of management report]*, that W Company's internal control 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, based on *[identify stated or established criteria]*.<sup>35</sup> Management is responsible for the suitable design of internal control over financial reporting. Our responsibility is to express an opinion on the design of internal control based on our examination.

##### *[Scope paragraph]*

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, evaluating the design of internal control, and performing 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, W Company's internal control over financial reporting is suitably designed, in all material respects, to prevent or detect material misstatements in the financial statements on a timely basis as of December 31, 19XX, based on *[identify established or stated criteria]*.

*[Signature]*

*[Date]*

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<sup>33</sup> See paragraph .22. [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Footnote subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

<sup>34</sup> 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. [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Footnote subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

<sup>35</sup> 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 as management uses in its report, including the kinds of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying *[title of management report]*" would be omitted. [Footnote added, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]



When reporting on the suitability of design of the entity's internal control 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 over financial reporting as of December 31, 19XX, and, accordingly, we express no opinion on operating effectiveness.

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

### **Management's Assertion Based on Criteria Specified by a Regulatory Agency**

.73 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 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 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 .46. 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.74 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 components does not reduce to a relatively low level the risk that misstatements due to error or fraud 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.

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.75 The following report illustrates one that a practitioner might use when he or she has examined management's assertion on the effectiveness of

the entity's internal control based on criteria established by a regulatory agency that did not follow due process.

Independent Accountant's Report

*[Introductory paragraph]*

We have examined management's assertion included in the accompanying *[title of management report]* that W Company's internal control 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 \_\_\_\_\_.<sup>36</sup> Management is responsible for maintaining internal control over financial reporting. Our responsibility is to express an opinion on whether internal control is adequate to meet such criteria based on our examination.

*[Standard scope and inherent limitations paragraphs]*

*[Opinion paragraph]*

We understand that the agency considers the controls 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, W Company's internal control over financial reporting is adequate, in all material respects, to meet the criteria established by \_\_\_\_\_ agency, based on 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.<sup>37</sup>

*[Signature]*

*[Date]*

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

**.76** When the practitioner issues this form of report, he or she does not assume any responsibility for the comprehensiveness of the criteria established

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<sup>36</sup> 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 as management uses in its report, including the kinds of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying *[title of management report]*" would be omitted. [Footnote added, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

<sup>37</sup> 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." [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Footnote subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.77 If a regulatory agency requires the reporting of all conditions (whether material or not) that are not in conformity with the agency's criteria, the practitioner should describe all conditions of which he or she is aware in the report. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## **Other Information in a Client-Prepared Document Containing the Practitioner's Report on the Effectiveness of the Entity's Internal Control**

.78 An entity may publish various documents that contain other information in addition to the practitioner's report on the effectiveness of the entity's internal control. 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 information 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 the practitioner's report, or whether such information contains a material misstatement of fact. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.79 If the practitioner believes that the other information is inconsistent with the information appearing in the practitioner's report, he or she should consider whether the practitioner's report requires revision. If the practitioner concludes that the report does 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal con-

trol over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.80 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 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.81 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

## **Relationship of the Practitioner's Examination of an Entity's Internal Control to the Opinion Obtained in an Audit**

.82 The purpose of a practitioner's examination of management's assertion about the effectiveness of an entity's internal control is to express an opinion about whether the entity maintained, in all material respects, effective internal control as of a point in time based on the control criteria. In contrast, the purpose of an auditor's consideration of internal control 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 is discussed in AU section 319. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.83 In a financial statement audit, the auditor obtains an understanding of internal control 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 controls are unlikely to pertain to the assertion, that controls 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 controls that are likely to prevent or detect material misstatements in that assertion and performs tests of controls to evaluate the effectiveness of such controls. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

**.84** An auditor's consideration of internal control 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. However, knowledge the practitioner obtains about the entity's internal control as part of the examination of management's assertion may serve as the basis for his or her understanding of internal control 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

**.85** While an examination of management's assertions about the effectiveness of the entity's internal control 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

## Relationship to the Foreign Corrupt Practices Act

**.86** 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

## Effective Date

**.87** This section is effective for an examination of management's assertion on the effectiveness of an entity's internal control over financial reporting when

the assertion is as of December 15, 1993, or thereafter. Earlier application of this section is encouraged. The amendments to this section are effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999; earlier application is encouraged. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## Appendix

The following documents contain guidance for practitioners engaged to provide other services in connection with an entity's internal control.

- AU section 325, *Communication of Internal Control 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, *Service Organizations*, provides guidance to auditors of a service organization on issuing a report on certain aspects of the service organization's internal control that can be used by other auditors, as well as guidance on how other auditors should use such reports.
- Audit and Accounting Guide *Audits of State and Local Governmental Units* 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* (1994 Revision), issued by the Comptroller General of the United States.
- SOP 98-3, *Audits of States, Local Governments, and 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* (1994 Revision), issued by the Comptroller General of the United States.

[Revised March, 1995 by the Auditing Standards Division due to the issuance of Statement on Auditing Standards No. 74. Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 6, December 1995. Paragraph subsequently renumbered and amended, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

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[The next page is 2811.]

## AT Section 9400

# Reporting on an Entity's Internal Control Over Financial Reporting: Attestation Engagements Interpretations of Section 400

### 1. Pre-Award Surveys

**.01 Question**—As part of the process of applying for a government grant or contract, an entity may be required to submit a written pre-award assertion (survey) by management about the effectiveness (suitability) of the design of an entity's internal control or a portion thereof for the government's purposes, together with a practitioner's report thereon. May a practitioner issue such a report based on the consideration of internal control in an audit of the entity's financial statements?

**.02 Interpretation**—No. The purpose of the consideration of an entity's internal control in a financial statement audit is to obtain an understanding sufficient to plan the audit and to determine the nature, timing and extent of audit tests to be performed and not to provide assurance on internal control. The consideration made in a financial statement audit does not provide the practitioner with a sufficient basis to issue a report expressing any assurance about the effectiveness of the design of internal control or any portion thereof.

**.03 Question**—How may a practitioner report on the design effectiveness of an entity's internal control or a portion thereof?

**.04 Interpretation**—In order to issue such a report, the practitioner should perform an examination of or apply agreed-upon procedures to management's written assertion about the effectiveness (suitability) of the design of an entity's internal control as described in section 400, *Reporting on an Entity's Internal Control Over Financial Reporting*, paragraphs .22 through .25 and .71 through .77. When the engagement involves the application of agreed-upon procedures to a written assertion about the design effectiveness of the entity's internal control over compliance with specified requirements, the practitioner should also follow the provisions of section 500, *Compliance Attestation*, paragraphs .09 and .14 through .28, and section 600, *Agreed-Upon Procedures Engagements*.

**.05 Question**—What are a practitioner's responsibilities when requested to sign a form prescribed by a government agency in connection with a pre-award survey?

**.06 Interpretation**—The practitioner should refuse to sign such a prescribed form unless he or she has performed an attestation engagement, as discussed in paragraph .04. If the practitioner has performed such an attestation engagement, he or she should consider whether the wording of the prescribed form conforms to the requirements of professional standards. For example, the prescribed form may contain a description of the practitioner's responsibilities or the practitioner's conclusions that is not in conformity with those standards. Some prescribed forms can be made acceptable by inserting additional or deleting existing wording; others can be made acceptable only by complete revision. When a prescribed form contains a statement or wording not in conformity with professional standards, the practitioner should either reword the form to conform to those standards or attach a separate report conforming with such standards in place of the prescribed form.



**.07 Question**—An entity may also be required to submit a written pre-award assertion (survey) about its *ability* to establish suitably designed internal control with an accompanying practitioner's report. May a practitioner issue such a report based on the consideration of existing internal control in an audit of an entity's financial statements or the performance of an attestation engagement?

**.08 Interpretation**—No. Neither the consideration of internal control in an audit of an entity's financial statements nor the performance of an attestation engagement provides the practitioner with a basis for issuing a report on the ability of an entity to establish suitably designed internal control. The assertion about *ability* is not capable of reasonably consistent estimation or measurement. The requesting agency may be willing to accept a report of the practitioner on a nonattest service as described in section 100, *Attestation Standards*, paragraphs .02 and .87. The practitioner should consider including in the nonattest service report—

- a. A statement that the practitioner is unable to perform an attest engagement on the entity's ability to establish suitably designed internal control because there are no criteria that are capable of reasonably consistent estimation or measurement for assessing such an assertion;
- b. A description of the nature and scope of the practitioner's services; and
- c. The practitioner's findings.

The practitioner may refer to the guidance in CS section 100, *Consulting Services: Definitions and Standards*.

[Issue Date: February, 1997.]

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[The next page is 2821.]

## AT Section 500

### Compliance Attestation

Source: SSAE No. 3; SAS No. 74; SSAE No. 4; SSAE No. 9.

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 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 over compliance with specified requirements.<sup>1</sup> 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.

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<sup>1</sup> 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 over compliance with specified requirements is referred to as its internal control over compliance. The internal control addressed in this section may include parts of, but is not the same as, internal control over financial reporting.

- c. Apply to engagements for which the objective is to report in accordance with AU section 801, *Compliance Auditing Considerations in 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 over compliance for a broker or dealer in securities as required by rule 17a-5 of the Securities Exchange Act of 1934.<sup>2</sup>

[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 of 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 over compliance<sup>3</sup>
- 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 over compliance. However,

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<sup>2</sup> An example of this report is contained in the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*.

<sup>3</sup> An entity's internal control over compliance is the process by which management obtains reasonable assurance of compliance with specified requirements. Although the comprehensive internal control 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 1b). The components of the internal control over compliance vary based on the nature of the compliance requirements. For example, an internal control over compliance with a capital requirement would generally include accounting procedures, whereas internal control over compliance with a requirement to practice nondiscriminatory hiring may not include accounting procedures.

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 or attached to the practitioner's report.<sup>4</sup> If a practitioner determines that such criteria do exist for internal control over compliance, he or she should perform the engagement in accordance with section 100. Additionally, section 400, *Reporting on an Entity's Internal Control Over Financial Reporting*, may be helpful to a practitioner in such an engagement. [As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.07 A practitioner should not accept an engagement to perform a review, as defined in section 100.44, of management's assertion about an entity's compliance with specified requirements or about the effectiveness of an entity's internal control over compliance.

.08 The guidance in this section does not apply unless management provides the practitioner with a written assertion. The written assertion may be provided to the practitioner in a representation letter or may be presented in a separate report that will accompany the practitioner's report. When management's assertion does not accompany the practitioner's report, the first paragraph of the report should also contain a statement of management's assertion. The practitioner may be engaged to provide other types of services in connection with the entity's compliance with specified requirements or the entity's internal control over compliance. For example, management may engage the practitioner to provide recommendations on how to improve the entity's compliance or related internal control. A practitioner engaged to provide such nonattest services should refer to the guidance in the Statement on Standards for Consulting Services (SSCS) No. 1, *Consulting Services: Definitions and Standards* [CS section 100]. [As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## Conditions for Engagement Performance

.09 A practitioner may perform an engagement related to an entity's compliance with specified requirements or the effectiveness of internal control over compliance if the following conditions, along with the applicable conditions in paragraph .11, are met:

- a. Management accepts responsibility for the entity's compliance with specified requirements and the effectiveness of the entity's internal control over compliance.
- b. Management evaluates the entity's compliance with specified requirements or the effectiveness of the entity's internal control over compliance.

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<sup>4</sup> 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 Committee of Sponsoring Organizations (COSO) of the Treadway Commission's Report, *Internal Control—Integrated Framework*, provides a general framework for effective internal control. 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 internal control 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 100.17 through .19, .76, and .77.)

- c. Management provides to the practitioner its written assertion about the entity's compliance with specified requirements or about the effectiveness of the entity's internal control over compliance.<sup>5</sup>

See also section 600, *Agreed-Upon Procedures Engagements*. [As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

[.10] [Superseded by Statement on Standards for Attestation Engagements No. 4, effective for reports on agreed-upon procedures engagements dated after April 30, 1996.] (See section 600.)

.11 A practitioner may perform an examination if, in addition to the conditions listed in paragraph .09, the following conditions are met.<sup>6]</sup>

- a. Management's assertion is capable of evaluation against reasonable criteria that either have been established by a recognized body or are stated in or attached to the practitioner's report 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.<sup>7</sup>
- b. Sufficient evidential matter exists or could be developed to support management's evaluation.

[As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

[.12] [Superseded by Statement on Standards for Attestation Engagements No. 4, effective for reports on agreed-upon procedures engagements dated after April 30, 1996.] (See section 600.)

.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

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<sup>5</sup> Management's written assertion may be in the form of a representation letter provided to the practitioner, an assertion addressed to a third party, or a prescribed schedule or declaration submitted to a third party. [Footnote added, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

<sup>6]</sup> [Footnote renumbered and deleted by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

<sup>7</sup> See footnote 4. [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

(a) identifying applicable compliance requirements, (b) establishing and maintaining internal control to provide reasonable assurance that the entity complies with those requirements, (c) 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 over compliance based on procedures agreed upon by the users of the report. A practitioner engaged to perform agreed-upon procedures on management's assertion about an entity's compliance with specified requirements or about the effectiveness of an entity's internal control over compliance should follow the guidance set forth herein and in section 600. [As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4.] (See section 600.)

.16 The practitioner's procedures generally may be as limited or as extensive as the specified users desire, as long as the specified users (a) agree upon the procedures performed or to be performed and (b) take responsibility for the sufficiency of the agreed-upon procedures for their purposes.<sup>[8]</sup> [As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4.] (See section 600.)

.17 To satisfy the requirements that the practitioner and the specified users agree upon the procedures performed or to be performed and that the specified users take responsibility for the sufficiency of the agreed-upon procedures for their purposes, ordinarily the practitioner should communicate directly with and obtain affirmative acknowledgment from each of the specified users. For example, this may be accomplished by meeting with the specified users or by distributing a draft of the anticipated report or a copy of an engagement letter to the specified users and obtaining their agreement. If the practitioner is not able to communicate directly with all of the specified users, the practitioner may satisfy these requirements by applying any one or more of the following or similar procedures:

- Compare the procedures to be applied to written requirements of the specified users.
- Discuss the procedures to be applied with appropriate representatives of the specified users involved.

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<sup>[8]</sup> [Footnote deleted by the issuance of Statement on Standards for Attestation Engagements No. 4, September 1995. Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

- Review relevant contracts with or correspondence from the specified users.

The practitioner should not report on an engagement when specified users do not agree upon the procedures performed or to be performed and do not take responsibility for the sufficiency of the procedures for their purposes. See section 600.38 for guidance on satisfying these requirements when the practitioner is requested to add parties as specified users after the date of completion of the agreed-upon procedures. [As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4.] (See section 600.)

**.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 over compliance, the practitioner is required to perform only the procedures that have been agreed to by users.<sup>9</sup> However, prior to performing such procedures, the practitioner should obtain an understanding of the specified compliance requirements, as discussed in paragraph .19. [As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4.] (See section 600.)

**.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

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<sup>9</sup> AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, does not apply to agreed-upon procedures engagements. [As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4 (see section 600). Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

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 .72.

.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 over compliance should be in the form of procedures and findings. The practitioner should not provide negative assurance about compliance or whether management's assertion is fairly stated. The practitioner's report should contain the following elements:

- a. A title that includes the word *independent*
- b. Identification of the specified users
- c. A reference to or statement of management's assertion about the entity's compliance with specified requirements, or about the effectiveness of an entity's internal control over compliance, including the period or point in time addressed in management's assertion,<sup>10</sup> and the character of the engagement
- d. A statement that the procedures, which were agreed to by the specified users identified in the report, were performed to assist the users in evaluating the entity's compliance with specified requirements or the effectiveness of its internal control over compliance, or management's assertion thereon
- e. Reference to attestation standards established by the American Institute of Certified Public Accountants
- f. A statement that the sufficiency of the procedures is solely the responsibility of the specified users and a disclaimer of responsibility for the sufficiency of those procedures
- g. A list of the procedures performed (or reference thereto) and related findings.<sup>[11]</sup> The practitioner should not provide negative assurance. See section 600.26.
- h. Where applicable, a description of any agreed-upon materiality limits. See section 600.27.
- i. A statement that the practitioner was not engaged to, and did not, perform an examination of management's assertion about compliance with specified requirements or about the effectiveness of an entity's internal control over compliance, a disclaimer of opinion thereon, and a statement that if the practitioner had performed additional procedures, other matters might have come to his or her attention that would have been reported

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<sup>10</sup> Generally, management's assertion about compliance with specified requirements will address a *period* of time, whereas an assertion about internal control over compliance will address a *point* in time. [As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4 (see section 600). Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

<sup>[11]</sup> [Footnote deleted by the issuance of Statement on Standards for Attestation Engagements No. 4, September 1995. Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]



- j. A statement of restrictions on the use of the report because it is intended to be used solely by the specified users (However, if the report is a matter of public record, the practitioner should include the following sentence: "However, this report is a matter of public record and its distribution is not limited.")
- k. Where applicable, reservations or restrictions concerning procedures or findings as discussed in section 600.35, .37, .41, and .42
- l. Where applicable, a description of the nature of the assistance provided by the specialist as discussed in section 600.21 through .23

[As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4 (see section 600). As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.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  
on Applying Agreed-Upon Procedures

We have performed the procedures enumerated below, which were agreed to by *[list specified 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]*.<sup>12, 13</sup> This agreed-upon procedures engagement was performed in accordance with attestation standards established by the American Institute of Certified Public Accountants. 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.]*

We were not engaged to, and did not, perform an examination, the objective of which would be the expression of an opinion on management's assertion. 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.

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<sup>12</sup> If management's assertion is stated in the practitioner's report and does not accompany the practitioner's report, the phrase "included in the accompanying *[title of management report]*" would be omitted. [As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4 (see section 600). Footnote renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

<sup>13</sup> 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]* and enumerated below, which were agreed to by *[list users of report]*, solely to assist the users in evaluating management's assertion about . . . ." [As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4 (see section 600). Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

This report is intended solely for the use of *[list or refer to specified users]* and should not be used by those who have not agreed to the procedures and taken responsibility for the sufficiency of the procedures for their purposes.

*[Signature]*

*[Date]*

[As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4 (see section 600). As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.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 over compliance in which the procedures and findings are enumerated rather than referenced.

Independent Accountant's Report  
on Applying Agreed-Up On Procedures

We have performed the procedures enumerated below, which were agreed to by *[list specified users]*, solely to assist the users in evaluating management's assertion about the effectiveness of *[name of entity]'s* internal control over compliance with *[list specified requirements]* as of *[date]*, included in the accompanying *[title of management report]*.<sup>14, 15</sup> This agreed-upon procedures engagement was performed in accordance with attestation standards established by the American Institute of Certified Public Accountants. 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.]*

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<sup>14</sup> If management's assertion is stated in the practitioner's report and does not accompany the practitioner's report, the phrase "included in the accompanying *[title of management report]*" would be omitted. [As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4 (see section 600). Footnote renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

<sup>15</sup> 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]* and enumerated below, which were agreed to by *[list users of report]*, solely to assist the users in evaluating management's assertion about . . ." [Footnote added, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

We were not engaged to, and did not, perform an examination, the objective of which would be the expression of an opinion on management's assertion. 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 use of *[list or refer to specified users]* and should not be used by those who have not agreed to the procedures and taken responsibility for the sufficiency of the procedures for their purposes.<sup>[16], [17]</sup>

*[Signature]*

*[Date]*

[As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4 (see section 600). As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.27 In some agreed-upon procedures engagements, management's assertion may address both compliance with specified requirements and the effectiveness of internal control over compliance. In these engagements, the practitioner may issue one report that addresses both. 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 over compliance with the aforementioned compliance requirements as of *[date]*, included in the accompanying *[title of management report]*.<sup>18</sup>

[As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.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 on an entity's compliance or whether management's assertion about such compliance is fairly stated, in all material respects, based on established or agreed-upon criteria. To express such an opinion, the practitioner accumulates sufficient evidence about the entity's compliance with specified requirements, thereby limiting attestation risk to an appropriately low level. [As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

<sup>[16]</sup> [Footnote deleted by the issuance of Statement on Standards for Attestation Engagements No. 4, September 1995. Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

<sup>[17]</sup> [Footnote deleted by the issuance of Statement on Standards for Attestation Engagements No. 4, September 1995. Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

<sup>18</sup> If management's assertion is stated in the practitioner's report and does not accompany the practitioner's report, the phrase "included in the accompanying *[title of management report]*" would be omitted. [Footnote added, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## Attestation Risk

.30 In an engagement to examine management's assertion about compliance with specified requirements, the practitioner seeks to obtain reasonable assurance that the entity complied, 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 internal control 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 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. [As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.31 Attestation risk is the risk that the practitioner may unknowingly fail to modify appropriately his or her opinion. 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 controls
- 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 controls
- 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

[As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

### ***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, *Consideration of Fraud in a Financial Statement Audit*, paragraphs .16 through .19. 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. [As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

### ***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 of 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 an entity's compliance with specified requirements or on management's assertion about such compliance. [As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## **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 over compliance (paragraphs .44 through .46).
- d. Obtain sufficient evidence including testing compliance with specified requirements (paragraphs .47 and .48).
- e. Consider subsequent events (paragraphs .49 through .51).

- f.* Form an opinion about whether the entity complied, in all material respects, with specified requirements (or whether management's assertion about such compliance is fairly stated in all material respects), based on the established or agreed-upon criteria.

[As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## Obtaining an Understanding of the Specified Compliance Requirements

**.39** A practitioner should obtain an understanding of the specified compliance requirements. 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 third-party specialist)

[As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## 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 100.31 through .36.

### 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 the control environment, particularly 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
- f. The similarity of operations 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 Internal Control Over Compliance**

.44 The practitioner should obtain an understanding of relevant portions of internal control 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 controls 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 internal control 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 internal control over compliance that could adversely affect 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 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 100.40 through .43, 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 the practitioner's report and prior to the issuance of his or her report. [As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.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 the practitioner's report and may affect 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

[As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.51 The second type consists of noncompliance that occurs subsequent to the period being reported on 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. [As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

### Forming an Opinion on Management's Assertion

.52 In evaluating whether the entity has complied, in all material respects, *for whether management's assertion about such compliance 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. [As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## Reporting

[.53] [Paragraph deleted by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.54 The practitioner's report on an examination, which is ordinarily addressed to the entity, should include the following:

- a. A title that includes the word *independent*.
- b. An identification of management's assertion about the entity's compliance with specified requirements, including the period covered by management's assertion.<sup>19</sup> When management's assertion does not accompany the practitioner's report, the first paragraph of the report should also contain a statement of management's assertion.
- c. A statement that compliance with the requirements addressed in management's assertion is the responsibility of the entity's management.
- d. A statement that the practitioner's responsibility is to express an opinion on the entity's compliance with those requirements or on management's assertion on such compliance based on his or her examination.
- e. A statement that the examination was conducted in accordance with attestation 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.
- f. A statement that the practitioner believes the examination provides a reasonable basis for his or her opinion.
- g. A statement that the examination does not provide a legal determination on the entity's compliance.
- h. The practitioner's opinion on whether the entity complied, in all material respects, with specified requirements [or *whether management's assertion about compliance with specified requirements is fairly stated, in all material respects,*] based on established or agreed-upon criteria.<sup>20, 21</sup> (See paragraph .63 for reporting on material non-compliance.)

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<sup>19</sup> 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. [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

<sup>20</sup> 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." [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

<sup>21</sup> Although the practitioner's report generally will be for general use, the practitioner is not precluded from restricting the use of the report. [Footnote renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

- i. When the assertion has been prepared in conformity with criteria specified by a regulatory agency or that have been agreed upon by the asserter and the specified parties, the practitioner's report should contain—
  - A statement of limitations on the use of the report because it is intended solely for specified parties (see the fourth reporting standard).<sup>22</sup>
  - A statement, when established criteria exist, that the assertion is not intended to be that which would have been presented if the assertion were presented based on *[identify established criteria]*.
- j. The manual or printed signature of the practitioner's firm.
- k. The date of the examination report.

[As amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.55 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 state management's assertion in the introductory paragraph. The opinion paragraph should report on the entity's compliance with the specified requirements. [Paragraph added, effective for reports on the effectiveness of an entity's internal control over financial reporting issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.56 The following is the form of report a practitioner should use when he or she is expressing an opinion on an entity's compliance with specified requirements during a period of time.

#### Independent Accountant's Report

##### *[Introductory paragraph]*

We have examined management's assertion, included in the accompanying *[title of management's report]*, that *[name of entity]* complied with *[list specified compliance requirements]* during the *[period]* ended *[date]*.<sup>23, 24</sup> Management is responsible for *[name of entity]*'s compliance with those requirements. Our responsibility is to express an opinion on *[name of entity]*'s compliance based on our examination.

##### *[Scope paragraph]*

Our examination was conducted in accordance with attestation 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

<sup>22</sup> In certain situations, however, criteria that have been specified by management and other report users may be reasonable for general distribution. [Footnote added, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

<sup>23</sup> 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. [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

<sup>24</sup> If management's assertion is stated in the practitioner's report and does not accompany the practitioner's report, the phrase "included in the accompanying *[title of management report]*" would be omitted. [Footnote added, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

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, *[name of entity]* complied, in all material respects, with the aforementioned requirements for the year ended December 31, 19XX.<sup>25</sup>

*[Restricted use paragraph]*

This report is intended solely for the information and use of *[list specified parties]* and is not intended to be and should not be used by anyone other than these specified parties.

*[Signature]*

*[Date]*

[Paragraph renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

[.57] [Paragraph renumbered and deleted by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.58 The following is the form of report that a practitioner should use when expressing an opinion on management's assertion about compliance with specified requirements.

Independent Accountant's Report

*[Introductory paragraph]*

We have examined management's assertion, included in the accompanying *[title of management report]*, that *[name of entity]* complied with *[list specified compliance requirements]* during the *[period]* ended *[date]*.<sup>26,27</sup> 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 *[name of entity]*'s compliance based on our examination.

*[Standard scope paragraphs]*

*[Opinion paragraph]*

In our opinion, management's assertion that *[name of entity]* complied with the aforementioned requirements during the *[period]* ended *[date]* is fairly stated, in all material respects.<sup>28</sup>

<sup>25</sup> If it is necessary to identify criteria (see footnote 20), the criteria should be identified in the opinion paragraph (for example, "... in all material respects, based on the criteria set forth in Attachment 1"). [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

<sup>26</sup> 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 compliance requirements as management uses in its report. [Footnote added, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

<sup>27</sup> If management's assertion is stated in the practitioner's report and does not accompany the practitioner's report, the phrase "included in the accompanying *[title of management report]*" would be omitted. [Footnote added, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

<sup>28</sup> If it is necessary to identify criteria (see footnote 20), the criteria should be identified in the opinion paragraph (for example, "...in all material respects, based on the criteria set forth in Attachment 1"). [Footnote added, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

*[Restricted use paragraph]*

This report is intended solely for the information and use of *[list specified parties]* and is not intended to be and should not be used by anyone other than these specified parties.<sup>[29]</sup>

*[Signature]*

*[Date]*

[Paragraph renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

**.59** [Paragraph renumbered and deleted by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]<sup>[30]</sup>

**.60** 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 compliance 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]*.

[Paragraph renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

**.61** The date of completion of the examination procedures should be used as the date of the practitioner's report. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

## Report Modifications

**.62** The practitioner should modify the standard report described in paragraph .58, if any of the following conditions exist:

- There is material noncompliance with specified requirements (paragraphs .63 through .70).
- There is a matter involving a material uncertainty (paragraph .71).
- There is a restriction on the scope of the engagement.<sup>31</sup>
- The practitioner decides to refer to the report of another practitioner as the basis, in part, for the practitioner's report.<sup>32</sup>

<sup>[29]</sup> [Footnote renumbered and deleted by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

<sup>[30]</sup> [Footnote renumbered and deleted by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

<sup>31</sup> The practitioner should refer to section 400.60 through .63 for guidance on a report modified for a scope restriction and adapt such guidance to the standard reports in this section. [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

<sup>32</sup> The practitioner should refer to section 400.64 and .65 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. [Footnote renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

[Paragraph renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## Material Noncompliance

.63 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 and, to most effectively communicate with the reader of the report, should state his or her opinion on the entity's specified compliance requirements, not on management's assertion. The nature of the report modification depends on whether management discloses, in its assertion, a description of the noncompliance with requirements. [Paragraph renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.64 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 (before the opinion paragraph) that describes the noncompliance. [Paragraph renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.65 The following is the form of report, modified with explanatory language, that a practitioner should use when he or she has concluded that a qualified opinion is appropriate under the circumstances.

### Independent Accountant's Report

#### *[Introductory paragraph]*

We have examined management's assertion, included in the accompanying *[title of management report]*, that, except for the noncompliance with *[list requirements]* described in the third paragraph, *[name of entity]* complied with *[list specified compliance requirements]* for the *[period]* ended *[date]*.<sup>33</sup> Management is responsible for compliance with those requirements. Our responsibility is to express an opinion on *[name of entity]*'s compliance based on our examination.

#### *[Standard 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, *[name of entity]* complied, in all material respects, with the aforementioned requirements for the *[period]* ended *[date]*.

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<sup>33</sup> If management's assertion is stated in the practitioner's report and does not accompany the practitioner's report, the phrase "included in the accompanying *[title of management report]*" would be omitted. [Footnote added, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

*[Restricted use paragraph]*

This report is intended solely for the information and use of *[list specified parties]* and is not intended to be and should not be used by anyone other than these specified parties.

*[Signature]*

*[Date]*

[Paragraph renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.66 The following is the form of report, modified with explanatory language, that a practitioner should use when he or she concludes that an adverse opinion is appropriate in the circumstances and management has appropriately modified its assertion for the noncompliance.

Independent Accountant's Report*[Introductory paragraph]*

We have examined management's assertion, included in the accompanying *[title of management report]*, that, because of the effect of the noncompliance described in the third paragraph, *[name of entity]* has not complied with *[list specified compliance requirements]* for the *[period]* ended *[date]*. Management is responsible for compliance with those requirements. Our responsibility is to express an opinion on *[name of entity]*'s compliance based on our examination.

*[Standard scope paragraph]**[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 effect of the noncompliance described in the third paragraph, *[name of entity]* has not complied with the aforementioned requirements for the *[period]* ended *[date]*.

*[Restricted use paragraph]*

This report is intended solely for the information and use of *[list specified parties]* and is not intended to be and should not be used by anyone other than these specified parties.

*[Signature]*

*[Date]*

[Paragraph added, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## Disagreements With Management

.67 In some circumstances, management may disagree with the practitioner over the existence of material noncompliance and, therefore, not include in its assertion to the practitioner a description of such noncompliance. Alternatively, management may describe noncompliance but assert to the practitioner that the entity complied with specified requirements. In such cases, the practitioner should express either a qualified or an adverse opinion directly on the entity's compliance, depending on the materiality of the noncompliance. In deciding whether to modify the opinion, and whether a modification should be a qualified or an adverse opinion, the practitioner should consider such factors

as the significance of the noncompliance to the entity and the pervasiveness of the noncompliance. [Paragraph renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.68 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.

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, except for the material noncompliance described in the third paragraph, *[name of entity]* complied with the aforementioned requirements for the *[period]* ended *[date]*.

*[Restricted use paragraph]*

This report is intended solely for the information and use of *[list specified parties]* and is not intended to be and should not be used by anyone other than these specified parties.

*[Signature]*

*[Date]*

[Paragraph renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.69 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, *[name of entity]* has not complied with the aforementioned requirements for the *[period]* ended *[date]*.

*[Restricted use paragraph]*

This report is intended solely for the information and use of *[list specified parties]* and is not intended to be and should not be used by anyone other than these specified parties.

*[Signature]*

*[Date]*

[Paragraph renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.70 If the practitioner's report on his or her examination of management's assertion about the entity's compliance with specified requirements is included in a document that also 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. [Paragraph renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

### **Material Uncertainty**

.71 In certain instances, the outcome of future events that may have a material effect on 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. 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. Accordingly, when a material uncertainty exists, the practitioner should consider whether sufficient evidence exists to form an unqualified opinion, or whether to express a qualified opinion or to disclaim an opinion. In the case of a qualified opinion or a disclaimer of opinion, the practitioner should report directly on the entity's compliance. [Paragraph renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## **Management's Representations**

.72 In an agreed-upon procedures engagement or an examination engagement, the practitioner should obtain management's written representations<sup>34</sup>—

- a. Acknowledging management's responsibility for complying with the specified requirements.
- b. Acknowledging management's responsibility for establishing and maintaining effective internal control over compliance.
- c. Stating that management has performed an evaluation of (1) the entity's compliance with specified requirements or (2) the entity's controls 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 internal control over compliance, as applicable, based on the stated or established criteria.
- e. Stating that management has disclosed to the practitioner all known noncompliance.

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<sup>34</sup> AU section 333, *Management 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. [Footnote renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]



- 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.

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

.73 Management's refusal to furnish all appropriate written representations also constitutes a limitation on the scope of the engagement that requires the practitioner to withdraw from an agreed-upon procedures engagement and issue 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. [As amended, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Standards for Attestation Engagements No. 4 (see section 600). Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

### **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 Over Compliance**

.74 An entity may publish various documents that contain information ("other information") in addition to the practitioner's report or management's assertion (report) on either (a) the entity's compliance with specified requirements or (b) the effectiveness of the entity's internal control 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 information included in his or her report or 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 his or her or management's report or whether such information contains a material misstatement of fact. [Paragraph renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.75 The practitioner should follow the guidance in section 400.78 through .80, if he or she believes the other information is inconsistent with the information appearing in the practitioner's or management's report or if he or she becomes aware of information that he or she believes is a material misstatement of fact. [Paragraph renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

## Effective Date

.76 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 .77. Earlier application of this section is encouraged. Amendments to this section are effective for reports issued on or after June 30, 1999; earlier application is encouraged. [Paragraph renumbered and amended, effective for reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9.]

.77 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. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 9, January 1999.]

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[The next page is 2861.]

## AT Section 600

# Agreed-Upon Procedures Engagements<sup>1</sup>

Source: SSAE No. 4.

Effective for reports on agreed-upon procedures engagements dated after April 30, 1996.

## Introduction and Applicability

.01 This section sets forth attestation standards and provides guidance to a practitioner concerning performance and reporting in all agreed-upon procedures engagements, except as noted in paragraph .02.<sup>1</sup> A practitioner also should refer to the following Statements on Standards for Attestation Engagements (SSAEs), which provide additional guidance for certain types of agreed-upon procedures engagements:

- a. Section 200, *Financial Forecasts and Projections*
- b. Section 500, *Compliance Attestation*

.02 This section does not apply to<sup>2</sup> —

- a. Situations in which an auditor reports on the application of agreed-upon procedures to one or more specified elements, accounts, or items of a financial statement,<sup>3</sup> pursuant to AU section 622, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*.<sup>4</sup>
- b. 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. Engagements for which the objective is to report in accordance with AU section 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, unless the terms of the engagement specify that the engagement be performed pursuant to SSAEs.

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<sup>1</sup> This section *supersedes* section 100, *Attestation Standards*, paragraphs .47, .48, and .66 through .69, and section 200, *Financial Forecasts and Projections*, paragraphs .53, .55, and .56. This section also *supersedes* section 400, *Reporting on an Entity's Internal Control Over Financial Reporting*, paragraph .09, and section 500, *Compliance Attestation*, paragraphs .10 and .12.

It also *amends* section 200.49 through .52, .54, and .57 and section 500, paragraphs .15 through .18, .23, .26, .73, and footnote 9 to paragraph .18.

Furthermore, as a consequence of the foregoing changes to existing standards, this section requires conforming changes to certain Statements on Auditing Standards (SASs) and related interpretations and to certain SSAEs and the interpretation "Responding to Requests for Reports on Matters Relating to Solvency" (section 9100.33-.44). In addition, the guidance in certain Audit and Accounting Guides and in Statement of Position (SOP) 90-1, *Accountants' Services on Prospective Financial Statements for Internal Use Only and Partial Presentations*, will be updated.

<sup>2</sup> The attest interpretation "Responding to Requests for Reports on Matters Relating to Solvency" (section 9100.33-.44) prohibits the performance of any attest engagements concerning assertions on matters of solvency or insolvency.

<sup>3</sup> When engaged to perform agreed-upon procedures on prospective financial information, the practitioner should follow the guidance in this section and in section 200.

<sup>4</sup> The practitioner may issue combined reports on engagements to apply agreed-upon procedures pursuant to paragraph .48 of this section and AU section 622.47.

- d. Circumstances covered by AU section 324, *Service Organizations*, paragraph .58, when the service auditor is requested to apply substantive procedures to user transactions or assets at the service organization and he or she makes specific reference in his or her service auditor's report to having carried out designated procedures. (However, this section applies when the service auditor provides a separate report on the performance of agreed-upon procedures in an attestation engagement.)
- e. Engagements covered by AU section 634, *Letters for Underwriters and Certain Other Requesting Parties*.
- f. An engagement for which there is no written assertion, as defined in paragraph .06. In such a situation, a practitioner may provide certain nonattest services involving advice or recommendations to a client. 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], or other applicable professional standards.
- g. Certain professional services that would not be considered as falling under this section as described in section 100, *Attestation Standards*, paragraph .02.

## Agreed-Upon Procedures Engagements

.03 An agreed-upon procedures engagement is one in which a practitioner is engaged by a client to issue a report of findings based on specific procedures performed on the subject matter of an assertion, as defined in paragraph .06. The client engages the practitioner to assist users in evaluating an assertion as a result of a need or needs of users of the report. Because users require that findings be independently derived, the services of a practitioner are obtained to perform procedures and report his or her findings. The users and the practitioner agree upon the procedures to be performed by the practitioner that the users believe are appropriate. Because users' needs may vary widely, the nature, timing, and extent of the agreed-upon procedures may vary as well; consequently, the users assume responsibility for the sufficiency of the procedures since they best understand their own needs. In an engagement performed under this section, the practitioner does not perform an examination or review (see section 100) and does not provide an opinion or negative assurance (see paragraph .26 of this section) about the assertion. Instead, the practitioner's report on agreed-upon procedures should be in the form of procedures and findings. (See paragraph .33 of this section.)

.04 As a consequence of the users' role in agreeing upon the procedures performed or to be performed, a practitioner's report on such engagements should clearly indicate that its use is restricted to those users. Those users, including the client, are hereinafter referred to as *specified users*.

## Standards

.05 The general, fieldwork, and reporting standards for attestation engagements as set forth in section 100, together with interpretive guidance regarding their application as addressed throughout this section, should be followed by the practitioner in performing and reporting on agreed-upon procedures engagements.

*General Standards*

- a. 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.* (section 100.09)
- b. 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.* (section 100.12)
- c. 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:*
  1. *The 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 be able to understand them.*
  2. *The assertion is capable of reasonably consistent estimation or measurement using such criteria.* (section 100.14)  
(Refer to paragraph .06 of this section.)
- d. 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.* (section 100.25)<sup>5</sup>
- e. The fifth general standard is—*Due professional care shall be exercised in the planning and performance of the engagement.* (section 100.28)

*Standards of Fieldwork*

- a. The first standard of fieldwork is—*The work shall be adequately planned and assistants, if any, shall be properly supervised.* (section 100.31)
- b. 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.* (section 100.40)  
(Refer to paragraph .18 of this section.)

*Standards of Reporting*

- a. The first standard of reporting is—*The report shall identify the assertion being reported on and state the character of the engagement.* (section 100.49)  
(Refer to paragraph .33 of this section.)
- b. The second standard of reporting is—*The report shall state the practitioner's conclusion about the reliability of the assertion based on the established or stated criteria against which it was measured.* (section 100.53)  
(Refer to paragraphs .06, .26 through .28, and .33 of this section.)
- c. The third standard of reporting is—*The report shall state all of the practitioner's significant reservations about the engagement and the assertion.* (section 100.70)  
(Refer to paragraphs .35, .37, .41, and .42 of this section.)

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<sup>5</sup> Practitioners performing attest engagements must be independent pursuant to rule 101 of the Code of Professional Conduct [ET section 101.01]. Interpretation 11 to rule 101 [ET section 101.13] provides guidance about its application in certain attest engagements (see ET section 101.13).

- d. The fourth standard of reporting is—*The report on an engagement to evaluate an assertion that has been prepared based on 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.* (section 100.76)

(Refer to paragraphs .04 and .38 of this section.)

## Assertions and Related Subject Matter

.06 An *assertion* is any declaration, or set of related declarations taken as a whole, by a party responsible for it. The *subject matter of an assertion* is any attribute, or subset of attributes, referred to or contained in an assertion and may in and of itself constitute an assertion. An assertion may be capable of reasonably consistent estimation or measurement using reasonable criteria as discussed in the third general standard; 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 an agreed-upon procedures engagement, it is the *specific subject matter of the assertion to which the agreed-upon procedures are to be applied* (referred to in this section as *specific subject matter*) that must satisfy the conditions set forth in the third general standard. Since the procedures are agreed upon between the practitioner and the specified users, the criteria against which the specific subject matter needs to be measurable may be recited within the procedures enumerated or referred to in the practitioner's report.

.07 The assertion should be presented in writing in a representation letter or another written communication from the responsible party (see paragraph .39). A written assertion may be presented to a practitioner in a number of ways, such as in a statement, narrative description, or schedule appropriately identifying what is being presented and the point in time or the period of time covered.

.08 Examples of written assertions include—

- A statement that an entity maintained effective internal controls over financial reporting based upon established criteria as of a certain date.
- A narrative description about an entity's compliance with requirements of specified laws, regulations, rules, contracts, or grants during a specified period (see section 500 for additional guidance).
- A representation by management that all investment securities owned by an entity during a specified period were traded on one or more of the markets specified in the entity's investment policy.
- A statement that the documentation of employee evaluations included in personnel files as of a certain date is dated within the time frame set forth in the entity's personnel policy.
- A schedule of statistical production data prepared in accordance with the policies of an identified entity for a specified period.

.09 In certain circumstances, the assertion may not have been finalized before determination that an attestation engagement will be undertaken by the practitioner and before all procedures have been agreed upon. This is a consequence of the evolving nature of these engagements, often to the point that the assertion is not finalized until shortly before the practitioner prepares his or her report. Typically, however, there is information identified to the

practitioner from which an assertion will be formulated. In any event, the responsible party should furnish the written assertion to the practitioner prior to issuance of his or her report on an agreed-upon procedures engagement.

## Conditions for Engagement Performance

.10 The practitioner may perform an agreed-upon procedures attestation engagement provided that—

- a. The practitioner is *independent*.
- b. The responsible party will provide the assertion in writing to the practitioner prior to the issuance of his or her report.
- c. The practitioner and the specified users agree upon the procedures performed or to be performed by the practitioner.
- d. The specified users take responsibility for the sufficiency of the agreed-upon procedures for their purposes.
- e. The specific subject matter to which the procedures are to be applied is subject to reasonably consistent estimation or measurement.
- f. Criteria to be used in the determination of findings are agreed upon between the practitioner and the specified users.
- g. The procedures to be applied to the specific subject matter are expected to result in reasonably consistent findings using the criteria.
- h. Evidential matter related to the specific subject matter to which the procedures are applied is expected to exist to provide a reasonable basis for expressing the findings in the practitioner's report.
- i. Where applicable, the practitioner and the specified users agree on any materiality limits for reporting purposes. (See paragraph .27.)
- j. Use of the report is restricted to the specified users.<sup>6</sup>
- k. For agreed-upon procedures engagements on prospective financial information, the prospective financial statements include a summary of significant assumptions (see section 200.50).
- l. For agreed-upon procedures engagements performed pursuant to section 500, management evaluates the entity's compliance with specified requirements or the effectiveness of the entity's internal control structure over compliance (see section 500.09).

## Agreement on and Sufficiency of Procedures

.11 To satisfy the requirements that the practitioner and the specified users agree upon the procedures performed or to be performed and that the specified users take responsibility for the sufficiency of the agreed-upon procedures for their purposes, ordinarily the practitioner should communicate directly with and obtain affirmative acknowledgment from each of the specified users. For example, this may be accomplished by meeting with the specified users or by distributing a draft of the anticipated report or a copy of an engagement letter to the specified users and obtaining their agreement. If the practitioner is not able to communicate directly with all of the specified users, the practitioner may satisfy these requirements by applying any one or more of the following or similar procedures:

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<sup>6</sup> A practitioner may perform an engagement pursuant to which his or her report will be a matter of public record. (See paragraph .33.)

- Compare the procedures to be applied to written requirements of the specified users.
- Discuss the procedures to be applied with appropriate representatives of the specified users involved.
- Review relevant contracts with or correspondence from the specified users.

The practitioner should not report on an engagement when specified users do not agree upon the procedures performed or to be performed and do not take responsibility for the sufficiency of the procedures for their purposes. (See paragraph .38 for guidance on satisfying these requirements when the practitioner is requested to add parties as specified users after the date of completion of the agreed-upon procedures.)

### **Establishing an Understanding With the Client**

.12 The practitioner should establish an understanding with the client regarding the services to be performed.<sup>\*</sup> When the practitioner documents the understanding through a written communication with the client (an “engagement letter”), such communication should be addressed to the client, and in some circumstances also to all specified users. Matters that might be included in such an understanding include the following:

- Nature of the engagement
- Identification of or reference to the assertion to be received and the party responsible for the assertion
- Identification of specified users (see paragraph .38)
- Specified users’ acknowledgment of their responsibility for the sufficiency of the procedures
- Responsibilities of the practitioner (see paragraphs .14 through .16 and .42)
- Reference to applicable AICPA standards
- Agreement on procedures by enumerating (or referring to) the procedures (see paragraphs .17 through .20)
- Disclaimers expected to be included in the practitioner’s report
- Use restrictions
- Assistance to be provided to the practitioner (see paragraphs .24 and .25)
- Involvement of a specialist (see paragraphs .21 through .23)
- Agreed-upon materiality limits (see paragraph .27)

## **Nature, Timing, and Extent of Procedures**

### **Users’ Responsibility**

.13 Specified users are responsible for the sufficiency (nature, timing, and extent) of the agreed-upon procedures, because they best understand their own needs. The specified users assume the risk that such procedures might be insufficient for their purposes. In addition, the specified users assume the risk that they might misunderstand or otherwise inappropriately use findings properly reported by the practitioner.

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\* Section 100.35, which provides guidance on establishing an understanding with the client regarding the services to be performed, applies to agreed-upon procedures engagements. [Footnote added, January 1998, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 7.]



## Practitioner's Responsibility

.14 The responsibility of the practitioner is to carry out the procedures and report the findings in accordance with the general, fieldwork, and reporting standards as discussed and interpreted in this section. The practitioner assumes the risk that misapplication of the procedures may result in inappropriate findings being reported. Furthermore, the practitioner assumes the risk that appropriate findings may not be reported or may be reported inaccurately. The practitioner's risks can be reduced through adequate planning and supervision and due professional care in performing the procedures, determining the findings, and preparing the report.

.15 The practitioner should have adequate knowledge in the specific subject matter to which the agreed-upon procedures are to be applied. He or she may obtain such knowledge through formal or continuing education, practical experience, or consultation with others.<sup>7</sup>

.16 The practitioner has no responsibility to determine the differences between the agreed-upon procedures to be performed and the procedures that the practitioner would have determined to be necessary had he or she been engaged to perform another form of attest engagement. The procedures that the practitioner agrees to perform pursuant to an agreed-upon procedures engagement may be more or less extensive than the procedures that the practitioner would determine to be necessary had he or she been engaged to perform another form of engagement.

## Procedures to Be Performed

.17 The procedures that the practitioner and specified users agree upon may be as limited or as extensive as the specified users desire. However, mere reading of an assertion or specified information does not constitute a procedure sufficient to permit a practitioner to report on the results of applying agreed-upon procedures. In some circumstances, the procedures agreed upon evolve or are modified over the course of the engagement. In general, there is flexibility in determining the procedures as long as the specified users acknowledge responsibility for the sufficiency of such procedures for their purposes. Matters that should be agreed upon include the nature, timing, and extent of the procedures.

.18 The practitioner should not agree to perform procedures that are overly subjective and thus possibly open to varying interpretations. Terms of uncertain meaning (such as *general review*, *limited review*, *reconcile*, *check*, or *test*) should not be used in describing the procedures unless such terms are defined within the agreed-upon procedures. The practitioner should obtain evidential matter from applying the agreed-upon procedures to provide a reasonable basis for the finding or findings expressed in his or her report, but need not perform additional procedures outside the scope of the engagement to gather additional evidential matter.

.19 Examples of appropriate procedures include—

- Execution of a sampling application after agreeing on relevant parameters.
- Inspection of specified documents evidencing certain types of transactions or detailed attributes thereof.

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<sup>7</sup> Section 500.18 and .19 provide guidance about obtaining an understanding of certain requirements in an agreed-upon procedures engagement involving management's assertion on compliance.

- Confirmation of specific information with third parties.
  - Comparison of documents, schedules, or analyses with certain specified attributes.
  - Performance of specific procedures on work performed by others (including the work of internal auditors—see paragraphs .24 and .25).
  - Performance of mathematical computations.
- .20 Examples of inappropriate procedures include—
- Mere reading of the work performed by others solely to describe their findings.
  - Evaluating the competency or objectivity of another party.
  - Obtaining an understanding about a particular subject.
  - Interpreting documents outside the scope of the practitioner's professional expertise.

### Involvement of a Specialist<sup>8</sup>

.21 The practitioner's education and experience enable him or her to be knowledgeable about business matters in general, but he or she is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. In certain circumstances, it may be appropriate to involve a specialist to assist the practitioner in the performance of one or more procedures. For example—

- An attorney might provide assistance concerning the interpretation of legal terminology involving laws, regulations, rules, contracts, or grants.
- A medical specialist might provide assistance in understanding the characteristics of diagnosis codes documented in patient medical records.

.22 The practitioner and the specified users should explicitly agree to the involvement of the specialist in assisting a practitioner in the performance of an agreed-upon procedures engagement. This agreement may be reached when obtaining agreement on the procedures performed or to be performed and acknowledgment of responsibility for the sufficiency of the procedures, as discussed in paragraph .11. The practitioner's report should describe the nature of the assistance provided by the specialist.

.23 A practitioner may agree to apply procedures to the report or work product of a specialist that does not constitute assistance by the specialist to the practitioner in an agreed-upon procedures engagement. For example, the practitioner may make reference to information contained in a report of a specialist in describing an agreed-upon procedure. However, it is inappropriate for the practitioner to agree to merely read the specialist's report solely to describe or repeat the findings, or to take responsibility for all or a portion of any procedures performed by a specialist or the specialist's work product.

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<sup>8</sup> A *specialist* is a person (or firm) possessing special skill or knowledge in a particular field other than the attest function. As used herein, a specialist does not include a person employed by the practitioner's firm who participates in the attestation engagement.

## Internal Auditors and Other Personnel<sup>9</sup>

.24 The agreed-upon procedures to be enumerated or referred to in the practitioner's report are to be performed entirely by the practitioner except as discussed in paragraphs .21 through .23. However, internal auditors or other personnel may prepare schedules and accumulate data or provide other information for the practitioner's use in performing the agreed-upon procedures. Also, internal auditors may perform and report separately on procedures that they have carried out. Such procedures may be similar to those that a practitioner may perform under this section.

.25 A practitioner may agree to perform procedures on information documented in the working papers of internal auditors. For example, the practitioner may agree to—

- Repeat all or some of the procedures.
- Determine whether the internal auditors' working papers contain documentation of procedures performed and whether the findings documented in the working papers are presented in a report by the internal auditors.

However, it is inappropriate for the practitioner to—

- Agree to merely read the internal auditors' report solely to describe or repeat their findings.
- Take responsibility for all or a portion of any procedures performed by internal auditors by reporting those findings as the practitioner's own.
- Report in any manner that implies shared responsibility for the procedures with the internal auditors.

## Findings

.26 A practitioner should present the results of applying agreed-upon procedures to specific subject matter in the form of findings. The practitioner should not provide negative assurance about whether the assertion is fairly stated in accordance with established or stated criteria. For example, the practitioner should not include a statement in his or her report that "nothing came to my attention that caused me to believe that the assertion is not fairly stated in accordance with (established or stated) criteria."

.27 The practitioner should report all findings from application of the agreed-upon procedures. The concept of materiality does not apply to findings to be reported in an agreed-upon procedures engagement unless the definition of materiality is agreed to by the specified users. Any agreed-upon materiality limits should be described in the practitioner's report.

.28 The practitioner should avoid vague or ambiguous language in reporting findings. Examples of appropriate and inappropriate descriptions of findings resulting from the application of certain agreed-upon procedures follow:

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<sup>9</sup> AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, does not apply to agreed-upon procedures engagements.

<i>Procedures Agreed Upon</i>	<i>Appropriate Description of Findings</i>	<i>Inappropriate Description of Findings</i>
Inspect the shipment dates for a sample (agreed-upon) of specified shipping documents and determine whether any such dates were subsequent to December 31, 19XX.	No shipment dates shown on the sample of shipping documents inspected were subsequent to December 31, 19XX.	Nothing came to my attention as a result of applying the procedure.
Calculate the number of blocks of streets paved during the year ended September 30, 19XX, shown on contractors' certificates of project completion; compare the resultant number to the number in an identified chart of performance statistics.	The number of blocks of street paved in the chart of performance statistics was Y blocks more than the number calculated from the contractors' certificates of project completion.	The number of blocks of streets paved approximated the number of blocks included in the chart of performance statistics.
Calculate the rate of return on a specified investment (according to an agreed-upon formula) and verify that the resultant percentage agrees to the percentage in an identified schedule.	No exceptions were found as a result of applying the procedure.	The resultant percentage approximated the predetermined percentage in the identified schedule.
Inspect the quality standards classification codes in identified performance test documents for products produced during a specified period; compare such codes to those shown in an identified computer printout.	All classification codes inspected in the identified documents were the same as those shown in the computer printout except for the following:  <i>[List all exceptions.]</i>	All classification codes appeared to comply with such performance test documents.

## Working Papers

.29 The practitioner should prepare and maintain working papers in connection with an agreed-upon engagement under the attestation standards; such working papers should be appropriate to the circumstances and the practitioner's needs on the engagement to which they apply.<sup>10</sup> Al-

<sup>10</sup> There is no intention to imply that the practitioner would be precluded from supporting his or her report by other means in addition to working papers.

though the quantity, type, and content of working papers vary with the circumstances, ordinarily they should indicate that—

- a. The work was adequately planned and supervised.
- b. Evidential matter was obtained to provide a reasonable basis for the finding or findings expressed in the practitioner's report.

**.30** Working papers are the property of the practitioner, and some states have statutes or regulations that designate the practitioner as the owner of the working papers. The practitioner's rights of ownership, however, are subject to ethical limitations relating to confidentiality.<sup>11</sup>

**.31** Certain of the practitioner's working papers may sometimes serve as a useful reference source for his or her client, but the working papers should not be regarded as a part of, or a substitute for, the client's records.

**.32** The practitioner should adopt reasonable procedures for safe custody of his or her working papers and should retain them for a period of time sufficient to meet the needs of his or her practice and satisfy any pertinent legal requirements of records retention.

## Reporting

### Required Elements

**.33** The practitioner's report on agreed-upon procedures should be in the form of procedures and findings. The practitioner's report should contain the following elements:

- a. A title that includes the word *independent*
- b. Identification of the specified users (see paragraph .38)
- c. Reference to the assertion<sup>12</sup> and the character of the engagement
- d. A statement that the procedures performed were those agreed to by the specified users identified in the report
- e. Reference to attestation standards established by the American Institute of Certified Public Accountants
- f. A statement that the sufficiency of the procedures is solely the responsibility of the specified users and a disclaimer of responsibility for the sufficiency of those procedures
- g. A list of the procedures performed (or reference thereto) and related findings (The practitioner should not provide negative assurance—see paragraph .26.)
- h. Where applicable, a description of any agreed-upon materiality limits (see paragraph .27)
- i. A statement that the practitioner was not engaged to, and did not, perform an examination of the assertion, a disclaimer of opinion on the assertion, and a statement that if the practitioner had performed additional procedures, other matters might have come to his or her attention that would have been reported<sup>13</sup>

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<sup>11</sup> For guidance on requests from regulators for access to working papers, see the interpretation "Providing Access to or Photocopies of Working Papers to a Regulator" (AU section 9339.01–15).

<sup>12</sup> In some agreed-upon procedures engagements, management may present more than one assertion. In these engagements, the practitioner may issue one report that refers to all assertions presented. (See section 500.27.)

<sup>13</sup> When the practitioner consents to the inclusion of his or her report on an agreed-upon procedures engagement in a document or written communication containing the entity's financial statements, he or she should refer to AU section 504, *Association With Financial Statements*, or to (footnote continued)

- j. A statement of restrictions on the use of the report because it is intended to be used solely by the specified users<sup>14</sup> (However, if the report is a matter of public record, the practitioner should include the following sentence: "However, this report is a matter of public record and its distribution is not limited.")
- k. Where applicable, reservations or restrictions concerning procedures or findings as discussed in paragraphs .35, .37, .41, and .42
- l. For an agreed-upon procedures engagement on prospective financial information, all items included in section 200.54
- m. Where applicable, a description of the nature of the assistance provided by a specialist as discussed in paragraphs .21 through .23

### Illustrative Report

.34 The following is an illustration of an agreed-upon procedures report.

Independent Accountant's Report  
on Applying Agreed-Upon Procedures

To the Audit Committees and Managements of ABC Inc. and XYZ Fund:

We have performed the procedures enumerated below, which were agreed to by the audit committees and managements of ABC Inc. and XYZ Fund, solely to assist you in evaluating the accompanying Statement of Investment Performance Statistics of XYZ Fund (prepared in accordance with the criteria specified therein) for the year ended December 31, 19X1. This agreed-upon procedures engagement was performed in accordance with attestation standards established by the American Institute of Certified Public Accountants. 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.]*

We were not engaged to, and did not, perform an examination, the objective of which would be the expression of an opinion on the accompanying Statement of Investment Performance Statistics of XYZ Fund. 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.

Statement on Standards for Accounting and Review Services (SSARS) 1, *Compilation and Review of Financial Statements* [AR section 100], as appropriate, for guidance on his or her responsibility pertaining to the financial statements.

The practitioner should follow (a) AU section 504.04 when the financial statements of a public or nonpublic entity are audited (or reviewed in accordance with AU section 722, *Interim Financial Information*), or (b) AU section 504.05 when the financial statements of a public entity are unaudited. The practitioner should follow SSARS 1, paragraph 6 [AR section 100.06] when (a) the financial statements of a nonpublic entity are reviewed or compiled or (b) the financial statements of a nonpublic entity are *not* reviewed or compiled and are not submitted by the accountant (as defined in SSARS 1, paragraph 7 [AR section 100.07]).

In addition, including or combining a report that is restricted to specified users with a report for general distribution results in restriction of all included reports to the specified users (see section 100.71).

<sup>14</sup> The purpose of the restriction on use of a practitioner's report on applying agreed-upon procedures is to limit its use to only those parties that have agreed upon the procedures performed and taken responsibility for the sufficiency of the procedures. Paragraph .38 describes the process for adding parties who were not originally contemplated in the agreed-upon procedures engagement.

This report is intended solely for the use of the audit committees and managements of ABC Inc. and XYZ Fund, and should not be used by those who have not agreed to the procedures and taken responsibility for the sufficiency of the procedures for their purposes.

### Explanatory Language

.35 The practitioner also may include explanatory language about matters such as the following:

- Disclosure of stipulated facts, assumptions, or interpretations (including the source thereof) used in the application of agreed-upon procedures (for example, see section 500.25)
- Description of the condition of records, controls, or data to which the procedures were applied
- Explanation that the practitioner has no responsibility to update his or her report
- Explanation of sampling risk

### Dating of Report

.36 The date of completion of the agreed-upon procedures should be used as the date of the practitioner's report.

### Restrictions on the Performance of Procedures

.37 When circumstances impose restrictions on the performance of the agreed-upon procedures, the practitioner should attempt to obtain agreement from the specified 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 any restrictions on the performance of procedures in his or her report or withdraw from the engagement.

### Adding Parties as Specified Users (Nonparticipant Parties)

.38 Subsequent to the completion of the agreed-upon procedures engagement, a practitioner may be requested to consider the addition of another party as a specified user (a nonparticipant party). The practitioner may agree to add a nonparticipant party as a specified user, based on consideration of such factors as the identity of the nonparticipant party and the intended use of the report.<sup>15</sup> If the practitioner does agree to add the nonparticipant party, he or she should obtain affirmative acknowledgment, normally in writing, from the nonparticipant party agreeing to the procedures performed and of its taking responsibility for the sufficiency of the procedures. If the nonparticipant party is added after the practitioner has issued his or her report, the report may be reissued or the practitioner may provide other written acknowledgment that the nonparticipant party has been added as a specified user. If the report is reissued, the report date should not be changed. If the practitioner provides written acknowledgment that the nonparticipant party has been added as a specified user, such written acknowledgment ordinarily should state that no procedures have been performed subsequent to the date of the report.

### Representations by Asserters

.39 As discussed in paragraph .07, the written assertion should be presented in a representation letter or another written communication from the

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<sup>15</sup> When considering whether to add a nonparticipant party, the guidance in AU section 530, *Dating of the Independent Auditor's Report*, paragraphs .06 and .07, may be helpful.

responsible party. The responsible party's refusal to furnish a written assertion constitutes a limitation on the performance of the engagement that requires the practitioner to withdraw from the engagement.

.40 A practitioner also may find a representation letter to be a useful and practical means of obtaining other representations from the responsible party. The need for such a letter may depend on the nature of the engagement and the specified users. For example, section 500.72 requires a practitioner to obtain a representation letter in an agreed-upon procedures engagement related to compliance with specified requirements. Examples of matters that might appear in a representation letter include a statement that the responsible party has disclosed to the practitioner—

- All known matters contradicting the assertion.
- Any communication from regulatory agencies affecting the assertion.

.41 The responsible party's refusal to furnish written representations determined by the practitioner to be appropriate for the engagement constitutes a limitation on the performance of the engagement. In such circumstances, the practitioner should do one of the following:

- a. Disclose in his or her report the inability to obtain representations from the responsible party.
- b. Withdraw from the engagement.<sup>16</sup>
- c. Change the engagement to another form of engagement.

## Knowledge of Matters Outside Agreed-Upon Procedures

.42 The practitioner need not perform procedures beyond the agreed-upon procedures. However, in connection with the application of agreed-upon procedures, if matters come to the practitioner's attention by other means that significantly contradict the assertion referred to in the practitioner's report, the practitioner should include this matter in his or her report. For example, if, during the course of applying agreed-upon procedures regarding management's assertion relating to the entity's internal control, the practitioner becomes aware of a material weakness by means other than performance of the agreed-upon procedure, the practitioner should include this matter in his or her report.

## Change to an Agreed-Upon Procedures Engagement From Another Form of Engagement

.43 A practitioner who has been engaged to perform another form of attest engagement or a nonattest service engagement may, before the engagement's completion, be requested to change the engagement to an agreed-upon procedures engagement under this section. A request to change the engagement may result from a change in circumstances affecting the client's requirements, a misunderstanding about the nature of the original services or the alternative services originally available, or a restriction on the performance of the original engagement, whether imposed by the client or caused by circumstances.

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<sup>16</sup> For an agreed-upon procedures engagement performed pursuant to section 500, management's refusal to furnish all required written representations also constitutes a limitation on the scope of the engagement that requires the practitioner to withdraw from the engagement. (See section 500.)



.44 Before a practitioner who was engaged to perform another form of engagement agrees to change the engagement to an agreed-upon procedures engagement, he or she should consider the following:

- a. The possibility that certain procedures performed as part of another type of engagement are not appropriate for inclusion in an agreed-upon procedures engagement
- b. The reason given for the request, particularly the implications of a restriction on the scope of the original engagement or the matters to be reported
- c. The additional effort required to complete the original engagement
- d. If applicable, the reasons for changing from a general-distribution report to a restricted-use report

.45 If the specified users acknowledge agreement to the procedures performed or to be performed and assume responsibility for the sufficiency of the procedures to be included in the agreed-upon procedures engagement, either of the following would be considered a reasonable basis for requesting a change in the engagement—

- a. A change in circumstances that requires another form of engagement
- b. A misunderstanding concerning the nature of the original engagement or the available alternatives

.46 In all circumstances, if the original engagement procedures are substantially complete or the effort to complete such procedures is relatively insignificant, the practitioner should consider the propriety of accepting a change in the engagement.

.47 If the practitioner concludes, based on his or her professional judgment, that there is reasonable justification to change the engagement, and provided he or she complies with the standards applicable to agreed-upon procedures engagements, the practitioner should issue an appropriate agreed-upon procedures report. The report should not include reference to either the original engagement or performance limitations that resulted in the changed engagement. (See paragraph .42.)

## Combined or Included Reports

.48 When a practitioner performs services pursuant to an engagement to apply agreed-upon procedures to specific subject matter as part of or in addition to another form of service, this section applies only to those services described herein; other Standards would apply to the other services. Other services may include an audit, review, or compilation of a financial statement, another attest service performed pursuant to the SSAEs, or a nonattest service.<sup>17</sup> Reports on applying agreed-upon procedures to specific subject matter may be included or combined with reports on such other services, provided the types of services can be clearly distinguished and the applicable Standards for each service are followed. However, since a practitioner's report on applying agreed-upon procedures to specific subject matter is restricted to the specified users, including or combining such a report with reports on other services results in restriction of all the included reports to the specified users.

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<sup>17</sup> See section 100.77 through .79 for requirements relating to attest services provided as part of an MAS engagement.

**Effective Date**

**.49** The effective date for this section is for reports on agreed-upon procedures engagements dated after April 30, 1996. Earlier application is encouraged.

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**[The next page is 2891.]**

## AT Section 700

# Management's Discussion and Analysis

Source: SSAE No. 8.

See section 9700 for interpretations of this section.

Effective upon issuance (March 1998).

## General

.01 This section sets forth attestation standards and provides guidance to a practitioner concerning the performance of an attest engagement<sup>1</sup> with respect to management's discussion and analysis (MD&A) prepared pursuant to the rules and regulations adopted by the Securities and Exchange Commission (SEC), which are presented in annual reports to shareholders and in other documents.<sup>2</sup> The presentation of MD&A constitutes a written assertion upon which an attest engagement may be performed.

## Applicability

.02 This section is applicable to the following levels of service when a practitioner is engaged by (a) a public entity<sup>3</sup> that prepares MD&A in accordance with the rules and regulations adopted by the SEC (see paragraph .04) or (b) a nonpublic entity that prepares an MD&A presentation and whose management provides a written assertion that the presentation has been prepared using the rules and regulations adopted by the SEC.<sup>4</sup>

- An examination of an MD&A presentation
- A review of an MD&A presentation for an annual period, an interim period, or a combined annual and interim period<sup>5</sup>

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<sup>1</sup> Section 100, *Attestation Standards*, paragraph .01, 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."

<sup>2</sup> Because this section provides guidance specific to attest engagements concerning MD&A presentations, a practitioner should not perform a compliance attestation engagement under section 500, *Compliance Attestation*, with respect to an MD&A presentation.

<sup>3</sup> For purposes of this section, a public entity is any entity (a) whose securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (b) that makes a filing with a regulatory agency in preparation for the sale of any class of its securities in a public market, or (c) a subsidiary, corporate joint venture, or other entity controlled by an entity covered by (a) or (b).

<sup>4</sup> Such assertion may be made by including either (a) a statement in the body of the MD&A presentation that it has been prepared using the rules and regulations adopted by the SEC or (b) a separate written assertion accompanying the MD&A presentation.

<sup>5</sup> As discussed in paragraph .86k, a review report is not intended to be filed with the SEC as a report under the Securities Act of 1933 (the 1933 Act) or the Securities Exchange Act of 1934 (the 1934 Act) and, accordingly, the review report should contain a statement of restrictions on the use of the report to specified parties if the entity is (a) a public entity or (b) a nonpublic entity that is making or has made an offering of securities and it appears that the securities may subsequently be registered or subject to a filing with the SEC or other regulatory agency.

A practitioner<sup>6</sup> engaged to examine or review MD&A and report thereon should comply with the general, fieldwork, and reporting standards in section 100, as amended, and the specific standards set forth in this section. A practitioner engaged to perform agreed-upon procedures on MD&A should follow the guidance set forth in section 600, *Agreed-Upon Procedures Engagements*, or AU section 622, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*.<sup>7</sup>

.03 This section does not—

- a. Change 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 the practitioner is requested to provide management with recommendations to improve the MD&A rather than to provide assurance. A practitioner engaged to provide such nonattest services should refer to the guidance in the Statement on Standards for Consulting Services (SSCS), *Consulting Services: Definitions and Standards* [CS section 100].
- c. Apply to situations in which the practitioner is engaged to provide attest services with respect to an MD&A presentation that is prepared based on criteria other than the rules and regulations adopted by the SEC. A practitioner engaged to provide such attest services should refer to the guidance in section 100 or section 600 (or AU section 622 when the practitioner is engaged to perform agreed-upon procedures to specified elements, accounts, or items of a financial statement included in MD&A).<sup>8</sup>

.04 The requirements for MD&A have changed periodically since the first requirement was adopted by the SEC in 1974. As of the date of issuance of this section, the rules and regulations for MD&A adopted by the SEC are found in Item 303 of Regulation S-K, as interpreted by Financial Reporting Release (FRR) No. 36, *Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures* (Section 501 of the "Codification of Financial Reporting Policies"), Item 303 of Regulation S-B for small business issuers, and Item 9 of Form 20-F for Foreign Private Issuers.<sup>9</sup> Item 303 of Regulation S-K, as interpreted by FRR No. 36, Item 303

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<sup>6</sup> In this section, the terms *practitioner* or *accountant* generally refer to a person engaged to perform an attest service on MD&A. The term *accountant* may also refer to a person engaged to review financial statements. The term *auditor* refers to a person engaged to audit financial statements. As this section includes certain requirements for the practitioner to have audited or performed a SAS No. 71 review of financial statements (*Interim Financial Information* [AU section 722]), the terms *auditor*, *practitioner*, or *accountant* may refer, in this section, to the same person.

<sup>7</sup> Practitioners should follow guidance in AU section 634, *Letters for Underwriters and Certain Other Requesting Parties*, as amended, when requested to perform agreed-upon procedures on MD&A and report thereon in a letter for an underwriter.

<sup>8</sup> The guidance in this section may be helpful when performing an engagement to provide attest services with respect to an MD&A presentation that is based on criteria other than the rules and regulations adopted by the SEC. Such other criteria would have to be suitable under the Attestation Standards as discussed in the section entitled "General Standards" in section 100.09–30.

<sup>9</sup> The SEC staff from time to time issues guidance related to the SEC's adopted requirements (for example, Staff Accounting Bulletins, Staff Legal Bulletins, and speeches). Although such guidance may provide additional information with respect to the adopted requirements for MD&A, the practitioner should not be expected to attest to assertions on compliance with such guidance. The practitioner may find it helpful to also familiarize himself or herself with material contained on the SEC's Web site that provides further information with respect to the SEC's views concerning MD&A disclosures.

of Regulation S-B for small business issuers, and Item 9 of Form 20-F for Foreign Private Issuers, provide the relevant rules and regulations adopted by the SEC that meet the definition of reasonable criteria in section 100.11–.17. The practitioner should consider whether the SEC has adopted additional rules and regulations with respect to MD&A subsequent to the issuance of this section.

## Conditions for Engagement Performance

### Examination

.05 The practitioner's objective in an engagement to examine MD&A is to express an opinion on the MD&A presentation taken as a whole by reporting whether—

- a. The presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC.<sup>10</sup>
- b. The historical financial amounts have been accurately derived, in all material respects, from the entity's financial statements.<sup>11</sup>
- c. The underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained therein.<sup>12</sup>

.06 A practitioner may accept an engagement to examine MD&A of a public or nonpublic entity, provided the practitioner audits, in accordance with GAAS,<sup>13</sup> the financial statements for at least the latest period to which the MD&A presentation relates and the financial statements for the other periods covered by the MD&A presentation have been audited by the practitioner or a predecessor auditor. A base knowledge of the entity and its operations gained through an audit of the historical financial statements and knowledge about the industry and the environment is necessary to provide the practitioner with sufficient knowledge to properly evaluate the results of the procedures performed in connection with the examination.

.07 If a predecessor auditor has audited the financial statements for a prior period covered by the MD&A presentation, the practitioner (the successor auditor) should also consider whether, under the particular circumstances, he or she can acquire sufficient knowledge of the business and of the entity's accounting and financial reporting practices for such period so that he or she would be able to—

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<sup>10</sup> The required elements as of the date of issuance of this Statement include a discussion of the entity's financial condition, changes in financial condition, and results of operations, including a discussion of liquidity and capital resources.

<sup>11</sup> Whether historical financial amounts are accurately derived from the financial statements includes both amounts that are derived from the face of the financial statements (which includes the notes to the financial statements) and financial statement schedules and those that are derived from underlying records supporting elements, accounts, or items included in the financial statements.

<sup>12</sup> Whether the underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained therein requires consideration of management's interpretation of the disclosure criteria for MD&A, management's determinations as to the relevancy of information to be included, and estimates and assumptions made by management that affect reported information.

<sup>13</sup> Restrictions on the scope of the audit of the financial statements will not necessarily preclude the practitioner from accepting an engagement to examine MD&A. Note that the SEC will generally not accept an auditor's report that is modified for a scope limitation. The practitioner should consider the nature and magnitude of the scope limitation and the form of the auditor's report in assessing whether an examination of MD&A could be performed.

- a. Identify types of potential material misstatements in MD&A and consider the likelihood of their occurrence.
- b. Perform the procedures that will provide the practitioner with a basis for expressing an opinion as to whether the MD&A presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC.
- c. Perform the procedures that will provide the practitioner with a basis for expressing an opinion on the MD&A presentation with respect to whether the historical financial amounts have been accurately derived, in all material respects, from the entity's financial statements for such period.
- d. Perform the procedures that will provide the practitioner with a basis for expressing an opinion as to whether the underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained therein.

Refer to paragraphs .100 through .102 for guidance regarding the review of the predecessor auditor's working papers.

### Review

.08 The objective of a review of MD&A is to report whether any information came to the practitioner's attention to cause him or her to believe that—

- a. The MD&A presentation does not include, in all material respects, the required elements of the rules and regulations adopted by the SEC.
- b. The historical financial amounts included therein have not been accurately derived, in all material respects, from the entity's financial statements.
- c. The underlying information, determinations, estimates, and assumptions of the entity do not provide a reasonable basis for the disclosures contained therein.

A review consists principally of applying analytical procedures and making inquiries of persons responsible for financial, accounting, and operational matters. A review ordinarily does not contemplate (a) tests of accounting records through inspection, observation, or confirmation, (b) obtaining corroborating evidential matter in response to inquiries, or (c) the application of certain other procedures ordinarily performed during an examination of MD&A. A review may bring to the practitioner's attention significant matters affecting the MD&A, but it does not provide assurance that the practitioner will become aware of all significant matters that would be disclosed in an examination.

.09 A practitioner may accept an engagement to review the MD&A presentation of a public entity for an annual period provided the practitioner has audited, in accordance with GAAS, the financial statements for at least the latest annual period to which the MD&A presentation relates and the financial statements for the other periods covered by the MD&A presentation have been audited by the practitioner or a predecessor auditor.<sup>14</sup> A base knowledge of the

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<sup>14</sup> As discussed in paragraph .86k, a review report is not intended to be filed with the SEC as a report under the 1933 Act or the 1934 Act and, accordingly, the review report should contain a statement of restrictions on the use of the report to specified parties if the entity is (a) a public entity or (b) a nonpublic entity that is making or has made an offering of securities and it appears that the securities may subsequently be registered or subject to a filing with the SEC or other regulatory agency.

entity and its operations gained through an audit of the historical financial statements and knowledge about the industry and the environment is necessary to provide the practitioner with sufficient knowledge to properly evaluate the results of the procedures performed in connection with the review.

.10 If a predecessor auditor has audited the financial statements for a prior period covered by the MD&A presentation, the practitioner should also consider whether, under the particular circumstances, he or she can acquire sufficient knowledge of the business and of the entity's accounting and financial reporting practices for such period so he or she would be able to—

- a. Identify types of potential material misstatements in the MD&A and consider the likelihood of their occurrence.
- b. Perform the procedures that will provide the practitioner with a basis for reporting whether any information has come to the practitioner's attention to cause him or her to believe any of the following:
  - (1) The MD&A presentation does not include, in all material respects, the required elements of the rules and regulations adopted by the SEC.
  - (2) The historical financial amounts included therein have not been accurately derived, in all material respects, from the entity's financial statements for such period.
  - (3) The underlying information, determinations, estimates, and assumptions of the entity do not provide a reasonable basis for the disclosures contained therein.

.11 A practitioner may accept an engagement to review the MD&A presentation of a public entity for an interim period provided that both of the following conditions are met.

- a. The practitioner performs either (1) a review of the historical financial statements for the related comparative interim periods and issues a review report thereon in accordance with AU section 722, *Interim Financial Information*, or (2) an audit of the interim financial statements.
- b. The MD&A presentation for the most recent fiscal year has been or will be examined or reviewed by either the practitioner or a predecessor auditor.

.12 If a predecessor auditor examined or reviewed the MD&A presentation of a public entity for the most recent fiscal year, the practitioner should not accept an engagement to review the MD&A presentation for an interim period unless he or she can acquire sufficient knowledge of the business and of the entity's accounting and financial reporting practices for the interim period to perform the procedures described in paragraph .10.

.13 If a nonpublic entity chooses to prepare MD&A, the practitioner should not accept an engagement to perform a review of such MD&A for an annual period under this section unless both of the following conditions are met.

- a. The annual financial statements for the periods covered by the MD&A presentation have been or will be audited and the practitioner has audited or will audit the most recent year (refer to paragraph .07 if the financial statements for prior years were audited by a predecessor auditor).

- b. Management will provide a written assertion that the presentation has been prepared using the rules and regulations adopted by the SEC as the criteria (see paragraph .02).
- .14 A practitioner may accept an engagement to review the MD&A presentation of a nonpublic entity for an interim period provided that all of the following conditions are met.
- a. The practitioner performs one of the following:
    - (1) A review of the historical financial statements for the related interim periods under the Statements on Standards for Accounting and Review Services and issues a review report thereon
    - (2) A review of the condensed interim financial information for the related interim periods under AU section 722 and issues a review report thereon, and such interim financial information is accompanied by complete annual financial statements for the most recent fiscal year that have been audited
    - (3) An audit of the interim financial statements
  - b. The MD&A presentation for the most recent fiscal year has been or will be examined or reviewed.
  - c. Management will provide a written assertion stating that the presentation has been prepared using the rules and regulations adopted by the SEC as the criteria (see paragraph .02).

### **Engagement Acceptance Considerations**

.15 In determining whether to accept an engagement, the practitioner should consider whether management (and others engaged by management to assist them, such as legal counsel) has the appropriate knowledge of the rules and regulations adopted by the SEC to prepare MD&A.

### **Responsibilities of Management**

.16 Management is responsible for the preparation of the entity's MD&A pursuant to the rules and regulations adopted by the SEC. The preparation of MD&A in conformity with the rules and regulations adopted by the SEC requires management to interpret the criteria, accurately derive the historical amounts from the entity's books and records, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information.

.17 An entity should not name the practitioner in a client-prepared document as having examined or reviewed MD&A unless the MD&A presentation and related practitioner's report and the related financial statements and auditor's (or accountant's review) report are included in the document (or, in the case of a public entity, incorporated by reference to such information filed with a regulatory agency). If such a statement is made in a document that does not include (or incorporate by reference) such information, the practitioner should request that neither his or her name nor reference to the practitioner be made with respect to the MD&A information, or that such document be revised to include the required presentations and reports. If the client does not comply, the practitioner should advise the client that he or she does not consent



to either the use of his or her name or the reference to the practitioner, and he or she should consider what other actions might be appropriate.<sup>15</sup>

## Obtaining an Understanding of the SEC Rules and Regulations and Management's Methodology for the Preparation of MD&A

.18 The practitioner should obtain an understanding of the rules and regulations adopted by the SEC for MD&A (refer to paragraph .04).

.19 The practitioner should inquire of management regarding the method of preparing MD&A, including matters such as the sources of the information, how the information is gathered, how management evaluates the types of factors having a material effect on financial condition (including liquidity and capital resources), results of operations, and cash flows, and whether there have been any changes in the procedures from the prior year.

## Timing of Procedures

.20 Proper planning by the practitioner contributes to the effectiveness of the attest procedures in an examination or a review of MD&A. Performing some of the work in conjunction with the audit of the historical financial statements or the review of interim financial statements may permit the work to be carried out in a more efficient manner and to be completed at an earlier date. When performing an examination or a review of MD&A, the practitioner may consider the results of tests of controls, analytical procedures,<sup>16</sup> and substantive tests performed in a financial statement audit or analytical procedures and inquiries made in a review of financial statements or interim financial information.

## Materiality

.21 The practitioner should consider the concept of materiality in planning and performing the engagement. The objective of an examination or a review is to report on the MD&A presentation taken as a whole and not on the individual amounts and disclosures contained therein. In the context of an MD&A presentation, the concept of materiality encompasses both material omissions (for example, the omission of trends, events, and uncertainties that are currently known to management that are reasonably likely to have material effects on the entity's financial condition, results of operations, liquidity, or capital resources) and material misstatements in MD&A, both of which are referred to herein as a misstatement. Assessing the significance of a misstatement of some items in MD&A may be more dependent upon qualitative than quantitative considerations. Qualitative aspects of materiality relate to the relevance and reliability of the information presented (for example, qualitative

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<sup>15</sup> In considering what other actions, if any, may be appropriate in these circumstances, the practitioner may wish to consult his or her legal counsel.

<sup>16</sup> AU section 329, *Analytical Procedures*, defines analytical procedures as "evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical procedures range from simple comparisons to the use of complex models involving many relationships and elements of data." In applying analytical procedures to MD&A, the practitioner develops expectations of matters that would be discussed in MD&A by identifying and using plausible relationships that are reasonably expected to exist based on the practitioner's understanding of the client and of the industry in which the client operates, and the knowledge of relationships among the various financial statement elements gained through the audit of financial statements or review of interim financial information. Refer to AU section 329 for further discussion of analytical procedures.

aspects of materiality are considered in assessing whether the underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures in the MD&A). Furthermore, quantitative information is often more meaningful when accompanied by qualitative disclosures. For example, quantitative information about market risk-sensitive instruments is more meaningful when accompanied by qualitative information about an entity's market risk exposures and how those exposures are managed. Materiality is also 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.

.22 For the purpose of assessing whether particular measurement and disclosure criteria can be expected to yield reasonably consistent estimates or measurements, materiality should be judged in light of the expected range of reasonableness for a particular assertion.

.23 In expressing an opinion, or providing the limited assurance of a review engagement, on the presentation, 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 using the MD&A presentation would be influenced by the inclusion or correction of the individual assertion. The relative, rather than absolute, size of an omission or misstatement may determine whether it is material in a given situation.

### **Inclusion of Pro Forma Financial Information**

.24 Management may include pro forma financial information with respect to a business combination or other transactions in MD&A. The practitioner should consider the guidance in section 300, *Reporting on Pro Forma Financial Information*, paragraph .10, when performing procedures with respect to such information, even if management indicates in MD&A that certain information has been derived from unaudited financial statements. For example, in an examination of MD&A, the practitioner's procedures would ordinarily include obtaining an understanding of the underlying transaction or event, discussing with management their assumptions, obtaining sufficient evidence in support of the adjustments, and other procedures for the purpose of expressing an opinion on the MD&A presentation taken as a whole and not for expressing an opinion on (or providing the limited assurance of a review of) the pro forma financial information included therein under section 300.

### **Inclusion of External Information**

.25 An entity may also include in its MD&A information external to the entity, such as the rating of its debt by certain rating agencies or comparisons with statistics from a trade association. Such external information should also be subjected to the practitioner's examination or review procedures. For example, in an examination, the practitioner might compare information concerning the statistics of a trade organization to a published source; however, the practitioner would not be expected to test the underlying support for the trade association's calculation of such statistics.

### **Inclusion of Forward-Looking Information**

.26 An entity may include certain forward-looking disclosures in the MD&A presentation, including cautionary language concerning the achievabil-

ity of the matters disclosed. Although any forward-looking disclosures that are included in the MD&A presentation should be subjected to the practitioner's examination or review, such information is subjected to testing only for the purpose of expressing an opinion that the underlying information, determinations, estimates, and assumptions provide a reasonable basis for the disclosures contained therein or providing the limited assurance of a review on the MD&A presentation taken as a whole. The practitioner may consider the guidance in section 200, *Financial Forecasts and Projections*, when performing procedures with respect to forward-looking information. The practitioner may also consider whether meaningful cautionary language has been included with the forward-looking information.

.27 Section 27A of the Securities Act of 1933 (1933 Act) and Section 21E of the Securities Exchange Act of 1934 (1934 Act) provide a safe harbor from liability in private litigation with respect to forward-looking statements that include or make reference to meaningful cautionary language. However, such sections also include exclusions from safe harbor protection in certain situations. Whether an entity's forward-looking statements and the practitioner's report thereon qualify for safe harbor protection is a legal matter.

### **Inclusion of Voluntary Information**

.28 An entity may voluntarily include other information in the MD&A presentation that is not required by the rules and regulations adopted by the SEC for MD&A. When the entity includes in MD&A additional information required by other rules and regulations of the SEC (for example, Item 305 of Regulation S-K, *Quantitative and Qualitative Disclosures About Market Risk*), the practitioner should also consider such other rules and regulations in subjecting such information to his or her examination or review procedures.<sup>17</sup>

### **Examination Engagement**

.29 To express an opinion about whether (a) the presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC, (b) the historical financial amounts have been accurately derived, in all material respects, from the entity's financial statements, and (c) the underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained therein, the practitioner seeks to obtain reasonable assurance by accumulating sufficient evidence in support of the disclosures and assumptions, thereby limiting attestation risk to an appropriately low level.

### **Attestation Risk**

.30 In an engagement to examine MD&A, the practitioner plans and performs the examination to obtain reasonable assurance of detecting both intentional and unintentional misstatements that are material to the MD&A presentation taken as a whole. Absolute assurance is not attainable because of factors such as the need for judgment regarding the areas to be tested and the nature, timing, and extent of tests to be performed; the concept of selective testing of the data; and the inherent limitations of the controls applicable to the preparation of MD&A. The practitioner exercises professional judgment in

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<sup>17</sup> To the extent that the voluntary information includes forward-looking information, refer to paragraphs .26 and .27.

assessing the significant determinations made by management as to the relevancy of information to be included, and the estimates and assumptions that affect reported information. As a result of these factors, in the great majority of cases, the practitioner has to rely on evidence that is persuasive rather than convincing. Also, procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion among client personnel and third parties or among management or employees of the client. Therefore, the subsequent discovery that a material misstatement exists in the MD&A does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment on the part of the practitioner, (c) the absence of due professional care, or (d) a failure to comply with this section.

.31 Factors to be considered by the practitioner in planning an examination of MD&A include (a) the anticipated level of attestation risk related to assertions embodied in the MD&A presentation, (b) preliminary judgments about materiality levels for attest purposes, (c) the items within the MD&A presentation that are likely to require revision or adjustment, and (d) conditions that may require extension or modification of attest procedures. For purposes of an engagement to examine MD&A, the components of attestation risk are defined as follows:

- a. *Inherent risk* is the susceptibility of an assertion (see paragraphs .35 through .39) within MD&A to a material misstatement, assuming that there are no related controls
- b. *Control risk* is the risk that a material misstatement that could occur in an assertion within MD&A will not be prevented or detected on a timely basis by the entity's controls; some control risk will always exist because of the inherent limitations of any internal control
- c. *Detection risk* is the risk that the practitioner will not detect a material misstatement that exists in an assertion within MD&A

### ***Inherent Risk***

.32 The level of inherent risk varies with the nature of the assertion. For example, the inherent risk concerning financial information included in the MD&A presentation may be low, whereas the inherent risk concerning the completeness of the disclosure of the entity's risks or liquidity may be high.

### ***Control Risk***

.33 The practitioner should assess control risk as discussed in paragraphs .54 through .58. Assessing control risk contributes to the practitioner's evaluation of the risk that material misstatement in the MD&A exists. In the process of assessing control risk (together with assessing inherent risk), the practitioner may obtain evidential matter about the risk that such misstatement may exist. The practitioner uses this evidential matter as part of the reasonable basis for his or her opinion on the MD&A presentation taken as a whole.

### ***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 tests performed based on the assessments of inherent risk and control risk.

## Nature of Assertions

.35 Assertions are representations by management that are embodied in the MD&A presentation. They can be either explicit or implicit and can be classified according to the following broad categories:

- a. Occurrence
- b. Consistency with the financial statements
- c. Completeness
- d. Presentation and disclosure

.36 Assertions about occurrence address whether reported transactions or events have occurred during a given period. Assertions about consistency with the financial statements address whether reported transactions, events, and explanations are consistent with the financial statements, whether historical financial amounts have been accurately derived from the financial statements and related records, and whether nonfinancial data have been accurately derived from related records.

.37 Assertions about completeness address whether descriptions of transactions and events necessary to obtain an understanding of the entity's financial condition (including liquidity and capital resources), changes in financial condition, results of operations, and material commitments for capital resources are included in MD&A; and whether known events, transactions, conditions, trends, demands, commitments, or uncertainties that will result in or are reasonably likely to result in material changes to these items are appropriately described in the MD&A presentation.

.38 For example, if management asserts that the reason for an increase in revenues is a price increase in the current year, they are explicitly asserting that both an increase in revenues and a price increase have occurred in the current year, and implicitly asserting that any historical financial amounts included are consistent with the financial statements for such period. They are also implicitly asserting that the explanation for the increase in revenues is complete; that there are no other significant reasons for the increase in revenues.

.39 Assertions about presentation and disclosure address whether information included in the MD&A presentation is properly classified, described, and disclosed. For example, management asserts that any forward-looking information included in MD&A is properly classified as being based on management's present assessment and includes an appropriate description of the expected results. To further disclose the nature of such information, management may also include a statement that actual results in the future may differ materially from management's present assessment (see paragraphs .26 and .27).

.40 The auditor of the underlying financial statements is responsible for obtaining and evaluating evidential matter concerning the assertions embodied in the account balance or transaction class of the financial statements as discussed in AU section 326, *Evidential Matter*, as amended. Although procedures designed to achieve the practitioner's objective of forming an opinion on the MD&A presentation taken as a whole may test certain assertions embodied in the underlying financial statements, the practitioner is not expected to test the underlying financial statement assertions in an examination of MD&A. For example, the practitioner is not expected to test the completeness of revenues

or the existence of inventory when testing the assertions in MD&A concerning an increase in revenues or an increase in inventory levels; assurance related to completeness of revenues or for existence of inventory would be obtained as part of the audit. The practitioner is, however, responsible for testing the completeness of the explanation for the increase in revenues or the increase in inventory levels.

## Performing an Examination Engagement

.41 The practitioner should exercise (a) due professional care in planning, performing, and evaluating the results of his or her examination procedures and (b) the proper degree of professional skepticism to obtain reasonable assurance that material misstatements will be detected.

.42 In an examination of MD&A, the practitioner should—

- a. Obtain an understanding of the rules and regulations adopted by the SEC for MD&A and management's method of preparing MD&A (paragraphs .18 and .19).
- b. Plan the engagement (paragraphs .43 through .49).
- c. Consider relevant portions of the entity's internal control applicable to the preparation of MD&A (paragraphs .50 through .59).
- d. Obtain sufficient evidence, including testing completeness (paragraphs .60 through .65).
- e. Consider the effect of events subsequent to the balance-sheet date (paragraphs .66 and .67).
- f. Obtain written representations from management concerning its responsibility for MD&A, completeness of minutes, events subsequent to the balance-sheet date, and other matters about which the practitioner believes written representations are appropriate (paragraphs .111 through .113).
- g. Form an opinion about whether the MD&A presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC, whether the historical financial amounts included therein have been accurately derived, in all material respects, from the entity's financial statements, and whether the underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained in the MD&A (paragraph .68).

## Planning the Engagement

### General Considerations

.43 Planning an engagement to examine MD&A involves developing an overall strategy for the expected 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 applicable to the preparation of MD&A obtained during the audit of the financial statements and the extent of recent changes, if any

- Matters relating to the entity's business, including its organization, operating characteristics, capital structure, and distribution methods
- The types of relevant information that management reports to external analysts (for example, press releases and presentations to lenders and rating agencies, if any, concerning past and future performance)
- How the entity analyzes actual performance compared to budgets and the types of information provided in documents submitted to the board of directors for purposes of the entity's day-to-day operations and long-range planning
- The extent of management's knowledge of and experience with the rules and regulations adopted by the SEC for MD&A
- If the entity is a nonpublic entity, the intended use of the MD&A presentation
- Preliminary judgments about (a) materiality, (b) inherent risk at the individual assertion level, and (c) factors (for example, matters identified during the audit or review of the historical financial statements) relating to significant deficiencies in internal control applicable to the preparation of MD&A (see paragraph .59)
- The fraud risk factors or other conditions identified during the audit of the most recent annual financial statements and the practitioner's response to such risk factors
- The type and extent of evidential matter supporting management's assertions and disclosures in the MD&A presentation
- The nature of complex or subjective matters potentially material to the MD&A presentation that may require special skill or knowledge and whether such matters may require using the work of a specialist to obtain sufficient evidential matter (see paragraph .48)
- The presence of an internal audit function (see paragraph .49)

.44 In planning an engagement when MD&A has not previously been examined, the practitioner should consider the degree to which the entity has information available for such prior periods and the continuity of the entity's personnel and their ability to respond to inquiries with respect to such periods. In addition, the practitioner should obtain an understanding of the entity's internal control in prior years applicable to the preparation of MD&A.

### **Consideration of Audit Results**

.45 The practitioner should also consider the results of the audits of the financial statements for the periods covered by the MD&A presentation on the examination engagement, such as matters relating to the following:

- The availability and condition of the entity's records
- The nature and magnitude of audit adjustments
- Likely misstatements<sup>18</sup> that were not corrected in the financial statements that may affect MD&A disclosures (for example, misclassifications between financial statement line items)

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<sup>18</sup> Refer to AU section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraphs .34 through .40, as amended.

.46 The practitioner should also consider the possible impact on the scope of the examination engagement of any modification or contemplated modification of the auditor's report, including matters addressed in explanatory language. For example, if the auditor has modified the auditor's report to include a going-concern uncertainty explanatory paragraph, the practitioner would consider such a matter in assessing attestation risk.

### **Multiple Components**

.47 In an engagement to examine MD&A, if the entity has operations in several components (for example, locations, branches, subsidiaries, or programs), the practitioner should determine the components to which procedures should be applied. In making such a determination and in selecting the components to be tested, the practitioner should consider factors such as the following:

- The relative importance of each component to the applicable MD&A disclosure
- The degree of centralization of records
- The effectiveness of controls, 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
- The nature and extent of operations conducted at the various components
- The similarity of operations and internal control for different components

The practitioner should consider whether the audit base of the components is consistent with the components that are disclosed in MD&A. Accordingly, it may be desirable for the practitioner to coordinate the audit work with the components that will be disclosed.

### **Using the Work of a Specialist**

.48 In some engagements to examine MD&A, the nature of complex or subjective matters potentially material to the MD&A presentation may require specialized skill or knowledge in a particular field other than accounting or auditing. For example, the entity may include information concerning plant production capacity, which would ordinarily be determined by an engineer. In such cases, the practitioner may use the work of a specialist and should consider the relevant guidance in AU section 336, *Using the Work of a Specialist*. AU section 311, *Planning and Supervision*, provides relevant guidance for situations in which a specialist employed by the practitioner's firm participates in the examination.

### **Internal Audit Function**

.49 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 directly testing the MD&A presentation, in monitoring the entity's internal control applicable to the preparation of MD&A, or in testing the underlying records supporting disclosures in the MD&A. 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 Internal Control Applicable to the Preparation of MD&A

.50 The practitioner should obtain an understanding of the entity's internal control applicable to the preparation of MD&A sufficient to plan the engagement and to assess control risk. Generally, controls that are relevant to an examination pertain to the entity's objective of preparing MD&A in conformity with the rules and regulations adopted by the SEC, and may include controls within the control environment, risk assessment, control activities, information and communication, and monitoring components.

.51 The controls relating to operations and compliance objectives may be relevant to an examination if they pertain to data the practitioner evaluates or uses in applying examination procedures. For example, controls over the gathering of information, which are different from financial statement controls, and controls relating to nonfinancial data that are included in the MD&A presentation, may be relevant to an examination engagement.

.52 In planning the examination, knowledge of such controls should be used to identify types of potential misstatement (including types of potential material omissions), to consider factors that affect the risk of material misstatement, and to design appropriate tests.

.53 A practitioner generally obtains an understanding of the design of the entity's internal control applicable to the preparation of MD&A by making inquiries of appropriate management, supervisory, and staff personnel; by inspection of the entity's documents; and by observation of the entity's relevant activities, including controls over matters discussed, nonfinancial data included, and management evaluation of the reasonableness of information included. The nature and extent of procedures a practitioner performs vary from entity to entity and are influenced by factors such as the entity's complexity, the length of time that the entity has prepared MD&A pursuant to the rules and regulations adopted by the SEC, the practitioner's knowledge of the entity's controls obtained in audits and previous professional engagements, and judgments about materiality.

.54 After obtaining an understanding of the entity's internal control applicable to the preparation of MD&A, the practitioner assesses control risk for the assertions embodied in the MD&A presentation (refer to paragraphs .35 through .40). The practitioner may assess control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's controls) because the practitioner believes controls are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient. Alternatively, the practitioner may obtain evidential matter about the effectiveness of both the design and operation of a control that supports a lower assessed level of control risk. Such evidential matter may be obtained from tests of controls planned and performed concurrently with obtaining the understanding of the internal control or from procedures performed to obtain the understanding that were not specifically planned as tests of controls.

.55 After obtaining the understanding and assessing control risk, the practitioner may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the practitioner considers whether evidential matter sufficient to support a further reduction is likely to be available and whether performing additional tests of controls to obtain such evidential matter would be efficient.

.56 When seeking to assess control risk below the maximum for controls over financial and nonfinancial data, the practitioner should perform tests of controls to obtain evidence to support the assessed level of control risk. For example, the practitioner may perform tests of controls directed toward the effectiveness of the design or operation of internal control over the accumulation of number of units sold for a manufacturing company, average interest rates earned and paid for a financial institution, or average net sales per square foot for a retail entity.

.57 The practitioner uses the knowledge provided by the understanding of internal control applicable to the preparation of MD&A and the assessed level of control risk in determining the nature, timing, and extent of substantive tests for the MD&A assertions.

.58 The practitioner should document the understanding of the internal control components obtained to plan the examination and the assessment of control risk. The form and extent of this documentation is influenced by the size and complexity of the entity, as well as the nature of the entity's controls applicable to the preparation of MD&A.

.59 During the course of an engagement to examine MD&A, the practitioner may become aware of significant deficiencies in the design or operation of internal control applicable to the preparation of MD&A that could adversely affect the entity's ability to prepare MD&A in accordance with the rules and regulations adopted by the SEC. The practitioner should consider the implications of such control deficiencies on his or her ability to rely on management's explanations and on comparisons to summary accounting records. A practitioner's responsibility to communicate these control deficiencies in an examination of MD&A is similar to the auditor's responsibility described in AU section 325, *Communication of Internal Control Related Matters Noted in an Audit*, and AU section 380, *Communication With Audit Committees*.

## Obtaining Sufficient Evidence

.60 The practitioner should apply procedures to obtain reasonable assurance of detecting material misstatements. In an audit of historical financial statements, the practitioner will have applied audit procedures to some of the information included in the MD&A. However, because the objective of those audit procedures is to have a reasonable basis for expressing an opinion on the financial statements taken as a whole rather than on the MD&A, certain additional examination procedures should be performed as discussed in paragraphs .61 through .65. Determining these procedures and evaluating the sufficiency of the evidence obtained are matters of professional judgment.

.61 The practitioner ordinarily should apply the following procedures:

- a. Read the MD&A and compare the content for consistency with the audited financial statements; compare financial amounts to the audited financial statements or related accounting records and analyses; recompute the increases, decreases, and percentages disclosed.
- b. Compare nonfinancial amounts to the audited financial statements, if applicable, or to other records (refer to paragraphs .63 through .65).
- c. Consider whether the explanations in MD&A are consistent with the information obtained during the audit; investigate further those explanations that cannot be substantiated by information in the audit working papers through inquiry (including inquiry of officers

and other executives having responsibility for operational areas) and inspection of client records.

- d. Examine internally generated documents (for example, variance analyses, sales analyses, wage cost analyses, sales or service pricing sheets, and business plans or programs) and externally generated documents (for example, correspondence, contracts, or loan agreements) in support of the existence, occurrence, or expected occurrence of events, transactions, conditions, trends, demands, commitments, and uncertainties disclosed in the MD&A.
- e. Obtain available prospective financial information (for example, budgets; sales forecasts; forecasts of labor, overhead, and materials costs; capital expenditure requests; and financial forecasts and projections) and compare such information to forward-looking MD&A disclosures. Inquire of management as to the procedures used to prepare the prospective financial information. Evaluate whether the underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the MD&A disclosures of events, transactions, conditions, trends, demands, commitments, or uncertainties.<sup>19</sup>
- f. Consider obtaining available prospective financial information relating to prior periods and comparing actual results with forecasted and projected amounts.
- g. Make inquiries of officers and other executives having responsibility for operational areas (such as sales, marketing, and production) and financial and accounting matters, as to their plans and expectations for the future that could affect the entity's liquidity and capital resources.
- h. Consider obtaining external information concerning industry trends, inflation, and changing prices and comparing the related MD&A disclosures to such information.
- i. Compare the information in MD&A with the rules and regulations adopted by the SEC and consider whether the presentation includes the required elements of such rules and regulations.
- j. Read the minutes of meetings to date of the board of directors and other significant committees to identify matters that may affect MD&A; consider whether such matters are appropriately addressed in MD&A.
- k. Inquire of officers as to the entity's prior experience with the SEC and the extent of comments received upon review of documents by the SEC; read correspondence between the entity and the SEC with respect to such review, if any.
- l. Obtain public communications (for example, press releases and quarterly reports) and the related supporting documentation dealing with historical and future results; consider whether MD&A is consistent with such communications.

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<sup>19</sup> Refer to paragraph .27 for a discussion concerning the safe harbor rules for forward-looking statements.

- m.* Consider obtaining other types of publicly available information (for example, analyst reports and news articles); compare the MD&A presentation with such information.

### **Testing Completeness**

.62 The practitioner should design procedures to test the presentation for completeness, including tests of the completeness of explanations that relate to historical disclosures as discussed in paragraphs .37 and .38. The practitioner should also consider whether the MD&A discloses matters that could significantly impact future financial condition and results of operations of the entity by considering information that he or she obtained through the audit of the financial statements; inquiries of the entity's officers and other executives directed to current events, conditions, economic changes, commitments and uncertainties, within both the entity and its industry; and other information obtained through procedures such as those listed in paragraphs .61, .66, and .67. As discussed in paragraph .32, the inherent risk concerning the completeness of disclosures may be high; if it is, the practitioner may extend the procedures (for example, by making additional inquiries of management or by examining additional internally generated documents).

### **Nonfinancial Data**

.63 Management may include nonfinancial data (such as units produced; the number of units sold, locations, or customers; plant utilization; or square footage) in the MD&A. The practitioner should consider whether the definitions used by management for such nonfinancial data are reasonable for the particular disclosure in the MD&A and whether there are reasonable criteria that have the characteristics of both relevance and reliability (for example, industry standards with respect to square footage for retail operations), as discussed in section 100.15 and .16.

.64 In some situations, the nonfinancial data or the controls over the nonfinancial data may have been tested by the practitioner in conjunction with the financial statement audit; however, the practitioner's consideration of the nature of the procedures to apply to nonfinancial data in an examination of MD&A is based on the concept of materiality with respect to the MD&A presentation. The practitioner should consider whether industry standards exist for the nonfinancial data or whether there are different methods of measurement that may be used, and, if such methods could result in significantly different results, whether the method of measurement selected by management is reasonable and consistent between periods covered by the MD&A presentation. For example, the number of customers reported by management could vary depending on whether management defines a customer as a subsidiary or "ship to" location of a company rather than the company itself.

.65 In testing nonfinancial data included in the MD&A, the practitioner may seek to assess control risk below the maximum for controls over such nonfinancial data, as discussed in paragraph .56. The practitioner weighs the increase in effort of the examination associated with the additional tests of controls that is necessary to obtain evidential matter against the resulting decrease in examination effort associated with the reduced substantive tests. For those nonfinancial assertions for which the practitioner performs additional tests of controls, the practitioner determines the assessed level of control risk that the results of those tests will support. This assessed level of control risk is used in determining the appropriate detection risk to accept for those nonfinancial assertions and, accordingly, in determining the nature, timing, and extent of substantive tests for such assertions.

## Consideration of the Effect of Events Subsequent to the Balance-Sheet Date

.66 As there is an expectation by the SEC that MD&A considers events through a date at or near the filing date,<sup>20</sup> the practitioner should consider information about events<sup>21</sup> that comes to his or her attention after the end of the period addressed by MD&A and prior to the issuance of his or her report that may have a material effect on the entity's financial condition (including liquidity and capital resources), changes in financial condition, results of operations, and material commitments for capital resources. Events or matters that should be disclosed in MD&A include those that—<sup>22</sup>

- Are reasonably expected to have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.
- Are reasonably likely to result in the entity's liquidity increasing or decreasing in any material way.
- Will have a material effect on the entity's capital resources.
- Would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.

The practitioner should consider whether events identified during the examination of the MD&A presentation or the audit of the related financial statements require adjustment to or disclosure in the MD&A presentation. When MD&A will be included or incorporated by reference in a 1933 Act document that is filed with the SEC, the practitioner's procedures should extend up to the filing date or as close to it as is reasonable and practicable in the circumstances.<sup>23</sup> If a public entity's MD&A presentation is to be included only in a filing under the 1934 Act (for example, Forms 10-K or 10-KSB), the practitioner's responsibility to consider subsequent events does not extend beyond the date of the report on MD&A. Paragraphs .95 through .99 provide guidance when the practitioner is engaged subsequent to the filing of the MD&A presentation.

.67 In an examination of MD&A, the practitioner's fieldwork ordinarily extends beyond the date of the auditor's report on the related financial statements.<sup>24</sup> Accordingly, the practitioner generally should—

- a. Read available minutes of meetings of stockholders, the board of directors, and other appropriate committees; as to meetings for which

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<sup>20</sup> A registration statement under the 1933 Act speaks as of its effective date.

<sup>21</sup> Such events are only referred to as *subsequent events* in relation to an MD&A presentation if they occur after the MD&A presentation has been issued. The annual MD&A presentation ordinarily would not be updated for subsequent events if an MD&A presentation for a subsequent interim period has been issued or the event has been reported through a filing on Form 8-K.

<sup>22</sup> The practitioner should refer to the rules and regulations adopted by the SEC for other examples of events that should be disclosed.

<sup>23</sup> Additionally, if the practitioner's report on MD&A is included or incorporated by reference in a 1933 Act document, the practitioner should extend his or her procedures with respect to subsequent events from the date of his or her report on MD&A up to the effective date or as close thereto as is reasonable and practicable in the circumstances.

<sup>24</sup> Undertaking an engagement to examine MD&A does not extend the auditor's responsibility to update the subsequent events review procedures for the financial statements beyond the date of the auditor's report. However, see AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. Also, see AU section 711, *Filings Under Federal Securities Statutes*, as to an auditor's responsibility when his or her report is included in a registration statement filed under the 1933 Act.

minutes are not available, inquire about matters dealt with at such meetings.

- b. Read the latest available interim financial statements for periods subsequent to the date of the auditor's report, compare them with the financial statements for the periods covered by the MD&A, and inquire of and discuss with officers and other executives having responsibility for operational, financial, and accounting matters (limited where appropriate to major locations) such matters as—
  - Whether interim financial statements have been prepared on the same basis as the audited financial statements.
  - Whether there were any significant changes in the entity's operations, liquidity, or capital resources in the subsequent period.
  - The current status of items in the financial statements for which the MD&A has been prepared, that were accounted for on the basis of tentative, preliminary, or inconclusive data.
  - Whether any unusual adjustments were made during the period from the balance sheet date to the date of inquiry.
- c. Make inquiries of members of senior management as to the current status of matters concerning litigation, claims, and assessments identified during the audit of the financial statements and of any new matters or unfavorable developments. Consider obtaining updated legal letters from legal counsel.<sup>25</sup>
- d. Consider whether there have been any changes in economic conditions or in the industry that could have a significant effect on the entity.
- e. Obtain written representations from appropriate officials as to whether any events occurred subsequent to the latest balance sheet date that would require disclosure in the MD&A (see paragraphs .111 through .113).
- f. Make such additional inquiries or perform such other procedures as considered necessary and appropriate to address questions that arise in carrying out the foregoing procedures, inquiries, and discussions.

## Forming an Opinion

.68 The practitioner should consider the concept of materiality discussed in paragraphs .21 through .23, and the impact of any modification of the auditor's report on the historical financial statements in forming an opinion on the examination of MD&A, including the practitioner's ability to evaluate the results of inquiries and other procedures.

## Reporting

.69 In order for the practitioner to issue a report on an examination of MD&A, the financial statements for the periods covered by the MD&A presentation and the related auditor's report(s) should accompany the MD&A pres-

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<sup>25</sup> See AU section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, for guidance concerning obtaining legal letters.

entation (or, with respect to a public entity, be incorporated in the document containing the MD&A by reference to information filed with a regulatory agency). In addition, if the entity is a nonpublic entity, either a statement should be included in the body of the MD&A presentation that it has been prepared using the rules and regulations adopted by the SEC or a separate written assertion should accompany the MD&A presentation.

.70 The practitioner's report on an examination of MD&A should include the following:

- a. A title that includes the word *independent*
- b. An identification of the MD&A presentation, including the period covered
- c. A statement that management is responsible for the preparation of the MD&A pursuant to the rules and regulations adopted by the SEC, and a statement that the practitioner's responsibility is to express an opinion on the presentation based on his or her examination
- d. A reference to the auditor's report on the related financial statements, and if the report was other than a standard report, the substantive reasons therefor
- e. A statement that the examination was made in accordance with attestation standards established by the AICPA and a description of the scope of an examination of MD&A
- f. A statement that the practitioner believes the examination provides a reasonable basis for his or her opinion
- g. A paragraph stating that—
  - (1) The preparation of MD&A requires management to interpret the criteria, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information
  - (2) Actual results in the future may differ materially from management's present assessment of information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties
- h. If the entity is a nonpublic entity, a statement that, although the entity is not subject to the rules and regulations of the SEC, the MD&A presentation is intended to be a presentation in accordance with the rules and regulations adopted by the SEC
- i. The practitioner's opinion on whether—
  - (1) The presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC
  - (2) The historical financial amounts have been accurately derived, in all material respects, from the entity's financial statements
  - (3) The underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained therein

- j. The manual or printed signature of the practitioner's firm
- k. The date of the examination report

Appendix A [paragraph .115], "Examination Reports," includes a standard examination report (see Example 1).

### **Dating**

.71 The practitioner's report on the examination of MD&A should be dated as of the completion of the practitioner's examination procedures. That date should not precede the date of the auditor's report on the latest historical financial statements covered by the MD&A.

### **Report Modifications**

.72 The practitioner should modify the standard report described in paragraph .70, if any of the following conditions exist:

- The presentation excludes a material required element under the rules and regulations adopted by the SEC (paragraph .73).
- The historical financial amounts have not been accurately derived, in all material respects, from the entity's financial statements (paragraph .73).
- The underlying information, determinations, estimates, and assumptions used by management do not provide the entity with a reasonable basis for the disclosure in the MD&A (paragraph .73).
- There is a restriction on the scope of the engagement (paragraph .74).
- The practitioner decides to refer to the report of another practitioner as the basis in part for his or her report (paragraph .75).
- The practitioner is engaged to examine the MD&A presentation after it has been filed with the SEC (or other regulatory agency) (paragraphs .95 through .99).

.73 The practitioner should express a qualified or an adverse opinion if the MD&A presentation excludes a material required element; historical financial amounts have not been accurately derived in all material respects; or the underlying information, determinations, estimates, and assumptions of the entity do not provide a reasonable basis for the disclosures (for example, there is a lack of consistency between management's method of measuring nonfinancial data between periods covered by the MD&A presentation). The basis for such opinion should be stated in the practitioner's report. Appendix A [paragraph .115] includes several examples of such modifications (see Example 2). Also refer to paragraph .108 for required communications with the audit committee.

.74 If the practitioner is unable to perform the procedures he or she considers necessary in the circumstances, the practitioner should modify the report or withdraw from the engagement. If the practitioner modifies the report, he or she should describe the limitation on the scope of the examination in an explanatory paragraph and qualify his or her opinion, or disclaim an opinion. However, limitations on the ability of the practitioner to perform necessary procedures could also arise because of the lack of adequate support for a significant representation in the MD&A. That circumstance may result in a conclusion that the unsupported representation constitutes a material misstatement of fact and, accordingly, the practitioner may qualify his or her opinion or express an adverse opinion, as described in paragraph .73.



### **Reference to Report of Another Practitioner**

.75 If another practitioner examined the MD&A presentation of a component (refer to paragraph .47), the practitioner may decide to make reference to such report of the other practitioner as a basis for his or her opinion on the consolidated MD&A presentation. The practitioner should disclose this fact in the introductory paragraph of the report and should refer to the report of the other practitioner in expressing an opinion on the consolidated MD&A presentation. These references indicate a division of responsibility for performance of the examination. Appendix A [paragraph .115] provides an example of a report for such a situation (see Example 3). Refer to paragraph .106 for guidance when the other practitioner does not issue a report.

### **Emphasis of a Matter**

.76 In a number of circumstances, the practitioner may wish to emphasize a matter regarding the MD&A presentation. For example, he or she may wish to emphasize that the entity has included information beyond the required elements of the rules and regulations adopted by the SEC. Such explanatory comments should be presented in a separate paragraph of the practitioner's report.

## **Review Engagement**

.77 The objective of a review engagement, including a review of MD&A for an interim period, is to accumulate sufficient evidence to provide the practitioner with a basis for reporting whether any information came to the practitioner's attention to cause him or her to believe that (a) the MD&A presentation does not include, in all material respects, the required elements of the rules and regulations adopted by the SEC, (b) the historical financial amounts included therein have not been accurately derived, in all material respects, from the entity's financial statements, or (c) the underlying information, determinations, estimates, and assumptions of the entity do not provide a reasonable basis for the disclosures contained therein. MD&A for an interim period may be a freestanding presentation or it may be combined with the MD&A presentation for the most recent fiscal year. Procedures for conducting a review of MD&A generally are limited to inquiries and analytical procedures, rather than also including search and verification procedures, concerning factors that have a material effect on financial condition, including liquidity and capital resources, results of operations, and cash flows. In a review engagement, the practitioner should—

- a. Obtain an understanding of the rules and regulations adopted by the SEC for MD&A and management's method of preparing MD&A (paragraphs .18 and .19).
- b. Plan the engagement (paragraph .78).
- c. Consider relevant portions of the entity's internal control applicable to the preparation of the MD&A (paragraph .79).
- d. Apply analytical procedures and make inquiries of management and others (paragraphs .80 and .81).
- e. Consider the effect of events subsequent to the balance-sheet date. The practitioner's consideration of such events in a review of MD&A is similar to the practitioner's consideration in an examination (refer to paragraphs .66 and .67).

- f. Obtain written representations from management concerning its responsibility for MD&A, completeness of minutes, events subsequent to the balance-sheet date, and other matters about which the practitioner believes written representations are appropriate (paragraph .111).
- g. Form a conclusion as to whether any information came to the practitioner's attention that causes him or her to believe that (1) the MD&A presentation does not include, in all material respects, the required elements of the rules and regulations adopted by the SEC, (2) the historical financial amounts included therein have not been accurately derived, in all material respects, from the entity's financial statements, or (3) the underlying information, determinations, estimates, and assumptions of the entity do not provide a reasonable basis for the disclosures contained therein.

### Planning the Engagement

.78 Planning an engagement to review MD&A involves developing an overall strategy for the analytical procedures and inquiries to be performed. When developing an overall strategy for the review 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
- Matters relating to the entity's business, including its organization, operating characteristics, capital structure, and distribution methods
- The types of relevant information that management reports to external analysts (for example, press releases or presentations to lenders and rating agencies concerning past and future performance)
- The extent of management's knowledge of and experience with the rules and regulations adopted by the SEC for MD&A
- If the entity is a nonpublic entity, the intended use of the MD&A presentation
- Matters identified during the audit or review of the historical financial statements relating to MD&A reporting, including knowledge of the entity's internal control applicable to the preparation of MD&A and the extent of recent changes, if any
- Matters identified during prior engagements to examine or review MD&A
- Preliminary judgments about materiality levels
- The nature of complex or subjective matters potentially material to the MD&A that may require special skill or knowledge
- The presence of an internal audit function and the extent to which internal auditors are involved in directly testing the MD&A presentation or underlying records

### Consideration of Internal Control Applicable to the Preparation of MD&A

.79 To perform a review of MD&A, the practitioner needs to have sufficient knowledge of the entity's internal control applicable to the preparation of MD&A to—

- Identify types of potential misstatements in MD&A, including types of material omissions, and consider the likelihood of their occurrence.
- Select the inquiries and analytical procedures that will provide a basis for reporting whether any information causes the practitioner to believe that—
  - a. The MD&A presentation does not include, in all material respects, the required elements of the rules and regulations adopted by the SEC, or the historical financial amounts included therein have not been accurately derived, in all material respects, from the entity's financial statements.
  - b. The underlying information, determinations, estimates, and assumptions of the entity do not provide a reasonable basis for the disclosures contained therein.

### Application of Analytical Procedures and Inquiries

.80 The practitioner ordinarily would not obtain corroborating evidential matter of management's responses to the practitioner's inquiries in performing a review of MD&A. The practitioner should, however, consider the consistency of management's responses in light of the results of other inquiries and the application of analytical procedures. The practitioner ordinarily should apply the following analytical procedures and inquiries.

- a. Read the MD&A presentation and compare the content for consistency with the audited financial statements (or reviewed interim financial information if MD&A includes interim information); compare financial amounts to the audited or reviewed financial statements or related accounting records and analyses; recompute the increases, decreases, and percentages disclosed.
- b. Compare nonfinancial amounts to the audited (or reviewed) financial statements, if applicable, or to other records (refer to paragraph .81).
- c. Consider whether the explanations in MD&A are consistent with the information obtained during the audit or the review of interim financial information; make further inquiries of officers and other executives having responsibility for operational areas as necessary.
- d. Obtain available prospective financial information (for example, budgets; sales forecasts; forecasts of labor, overhead, and materials costs; capital expenditure requests; and financial forecasts and projections) and compare such information to forward-looking MD&A disclosures. Inquire of management as to the procedures used to prepare the prospective financial information. Consider whether information came to the practitioner's attention that causes him or her to believe that the underlying information, determinations, estimates, and assumptions of the entity do not provide a reasonable basis for the disclosures of trends, demands, commitments, events, or uncertainties.<sup>26</sup>
- e. Make inquiries of officers and other executives having responsibility for operational areas (such as sales, marketing, and production) and financial and accounting matters, as to any plans and expectations for the future that could affect the entity's liquidity and capital resources.

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<sup>26</sup> Refer to paragraph .27 for a discussion concerning the safe harbor rules for forward-looking statements.

- f. Compare the information in MD&A with the rules and regulations adopted by the SEC and consider whether the presentation includes the required elements of such rules and regulations.
- g. Read the minutes of meetings to date of the board of directors and other significant committees to identify actions that may affect MD&A; consider whether such matters are appropriately addressed in the MD&A presentation.
- h. Inquire of officers as to the entity's prior experience with the SEC and the extent of comments received upon review of documents by the SEC; read correspondence between the entity and the SEC with respect to such review, if any.
- i. Inquire of management regarding the nature of public communications (for example, press releases and quarterly reports) dealing with historical and future results and consider whether the MD&A presentation is consistent with such communications.

.81 If nonfinancial data are included in the MD&A presentation, the practitioner should inquire as to the nature of the records from which such information was derived and observe the existence of such records, but need not perform other tests of such records beyond analytical procedures and inquiries of individuals responsible for maintaining them. The practitioner should consider whether such nonfinancial data are relevant to users of the MD&A presentation and whether such data are clearly defined in the MD&A presentation. The practitioner should make inquiries regarding whether the definition of the nonfinancial data was consistently applied during the periods reported.

.82 However, if the practitioner becomes aware that the presentation may be incomplete or contain inaccuracies, or is otherwise unsatisfactory, the practitioner should perform the additional procedures he or she deems necessary to achieve the limited assurance contemplated by a review engagement.

## Reporting

.83 In order for the practitioner to issue a report on a review of MD&A for an annual period, the financial statements for the periods covered by the MD&A presentation and the related auditor's report(s) should accompany the MD&A presentation (or with respect to a public entity be incorporated in the document containing the MD&A by reference to information filed with a regulatory agency).

.84 If the MD&A presentation relates to an interim period and the entity is a public entity, the financial statements for the interim periods covered by the MD&A presentation and the related accountant's review report(s) should accompany the MD&A presentation, or be incorporated in the document containing the MD&A by reference to information filed with a regulatory agency. The comparative financial statements for the most recent annual period and the related MD&A should accompany the MD&A presentation for the interim period, or be incorporated by reference to information filed with a regulatory agency. Generally, the requirement for inclusion of the annual financial statements and related MD&A is satisfied by a public entity that has met its reporting responsibility for filing its annual financial statements and MD&A in its annual report on Form 10-K.

.85 If the MD&A presentation relates to an interim period and the entity is a nonpublic entity, the following documents should accompany the interim MD&A presentation in order for the practitioner to issue a review report:

- a. The MD&A presentation for the most recent fiscal year and related accountant's examination or review report(s)
- b. The financial statements for the periods covered by the respective MD&A presentations (most recent fiscal year and interim periods and the related auditor's report(s) and accountant's review report(s))

In addition, a statement should be included in the body of the MD&A presentation that it has been prepared using the rules and regulations adopted by the SEC or a separate written assertion should accompany the MD&A presentation.

.86 The practitioner's report on a review of MD&A should include the following:

- a. A title that includes the word *independent*
- b. An identification of the MD&A presentation, including the period covered
- c. A statement that management is responsible for the preparation of the MD&A pursuant to the rules and regulations adopted by the SEC
- d. A reference to the auditor's report on the related financial statements, and, if the report was other than a standard report, the substantive reasons therefor
- e. A statement that the review was conducted in accordance with attestation standards established by the AICPA
- f. A description of the procedures for a review of MD&A
- g. A statement that a review of MD&A is substantially less in scope than an examination, the objective of which is an expression of opinion regarding the MD&A presentation, and accordingly, no such opinion is expressed
- h. A paragraph stating that (1) the preparation of MD&A requires management to interpret the criteria, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information, and (2) actual results in the future may differ materially from management's present assessment of information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties
- i. If the entity is a nonpublic entity, a statement that although the entity is not subject to the rules and regulations of the SEC, the MD&A presentation is intended to be a presentation in accordance with the rules and regulations adopted by the SEC
- j. A statement about whether any information came to the practitioner's attention that caused him or her to believe that (1) the MD&A presentation does not include, in all material respects, the required elements of the rules and regulations adopted by the SEC, (2) the historical financial amounts included therein have not been accurately derived, in all material respects, from the entity's financial statements, or (3) the underlying information, determinations, estimates, and assumptions of the entity do not provide a reasonable basis for the disclosures contained therein

- k. If the entity is a public entity as defined in paragraph .02, or a nonpublic entity that is making or has made an offering of securities and it appears that the securities may subsequently be registered or subject to a filing with the SEC or other regulatory agency (for example, certain offerings of securities under Rule 144A of the 1933 Act that purport to conform to Regulation S-K), a statement of restrictions on the use of the report to specified parties, because it is not intended to be filed with the SEC as a report under the 1933 Act or the 1934 Act.
- l. The manual or printed signature of the practitioner's firm
- m. The date of the review report

Appendix B [paragraph .116], "Review Reports," provides examples of a standard review report for an annual and interim period.

### **Dating**

.87 The practitioner's report on the review of MD&A should be dated as of the completion of the practitioner's review procedures. That date should not precede the date of the accountant's report on the latest historical financial statements covered by the MD&A.

### **Report Modifications**

.88 The practitioner should modify the standard review report described in paragraph .86 if any of the following conditions exist.

- The presentation excludes a material required element of the rules and regulations adopted by the SEC (paragraph .90).
- The historical financial amounts have not been accurately derived, in all material respects, from the entity's financial statements (paragraph .90).
- The underlying information, determinations, estimates, and assumptions used by management do not provide the entity with a reasonable basis for the disclosures in the MD&A (paragraph .90).
- The practitioner decides to refer to the report of another practitioner as the basis, in part, for his or her report (paragraph .91).
- The practitioner is engaged to review the MD&A presentation after it has been filed with the SEC (or other regulatory agency) (paragraphs .95 through .99).

.89 When the practitioner is unable to perform the inquiry and analytical procedures he or she considers necessary to achieve the limited assurance provided by a review, or the client does not provide the practitioner with a representation letter, the review will be incomplete. A review that is incomplete is not an adequate basis for issuing a review report. If the practitioner is unable to complete a review because of a scope limitation, the practitioner should consider the implications of that limitation with respect to possible misstatements of the MD&A presentation. In those circumstances, the practitioner should also refer to paragraphs .108 through .110 for guidance concerning communications with the audit committee.

.90 If the practitioner becomes aware that the MD&A is materially misstated, the practitioner should modify the review report to describe the nature of the misstatement. Appendix B [paragraph .116] contains an example of such a modification of the accountant's report (see Example 3).

.91 If another practitioner reviewed or examined the MD&A for a material component, the practitioner may decide to make reference to such report of the other practitioner in reporting on the consolidated MD&A presentation. Such reference indicates a division of responsibility for performance of the review.

### ***Emphasis of a Matter***

.92 In some circumstances, the practitioner may wish to emphasize a matter regarding the MD&A presentation. For example, he or she may wish to emphasize that the entity has included information beyond the required elements of the rules and regulations adopted by the SEC. Such explanatory comments should be presented in a separate paragraph of the practitioner's report.

## **Combined Examination and Review Report on MD&A**

.93 A practitioner may be engaged both to examine an MD&A presentation as of the most recent fiscal year-end and to review a separate MD&A presentation for a subsequent interim period. If the examination and review are completed at the same time, a combined report may be issued. Appendix C [paragraph .117], "Combined Reports," contains an example of a combined report on an examination of an annual MD&A presentation and the review of a separate MD&A presentation for an interim period (see Example 1).

.94 If an entity prepares a combined MD&A presentation for annual and interim periods in which there is a discussion of liquidity and capital resources only as of the most recent interim period but not as of the most recent annual period, the practitioner is limited to performing the highest level of service that is provided with respect to the historical financial statements for any of the periods covered by the MD&A presentation. For example, if the annual financial statements have been audited and the interim financial statements have been reviewed, the practitioner may be engaged to perform a review of the combined MD&A presentation. Appendix C [paragraph .117] contains an example of a review report on a combined MD&A presentation for annual and interim periods (see Example 2).

## **When Practitioner Is Engaged Subsequent to the Filing of MD&A**

.95 Management's responsibility for updating an MD&A presentation for events occurring subsequent to the issuance of MD&A depends on whether the entity is a public or nonpublic entity. A public entity is required to report significant subsequent events in a Form 8-K or Form 10-Q, or in a registration statement; therefore, a public company would ordinarily not modify its MD&A presentation once it is filed with the SEC (or other regulatory agency).

.96 Therefore, if the practitioner is engaged to examine (or review) an MD&A presentation of a public entity that has already been filed with the SEC (or other regulatory agency), the practitioner should consider whether material subsequent events are appropriately disclosed in a Form 8-K or 10-Q, or a registration statement that includes or incorporates by reference such MD&A presentation. Refer to paragraphs .66 and .67 for guidance concerning consideration of events up to the filing date when the practitioner's report on MD&A will be included (or incorporated by reference) in a 1933 Act document filed with the SEC that will require a consent.

**.97** If subsequent events of a public entity are appropriately disclosed in a Form 8-K or 10-Q, or in a registration statement, or if there have been no material subsequent events, the practitioner should add the following paragraph to his or her examination or review report following the opinion or concluding paragraph, respectively:

The accompanying Management's Discussion and Analysis does not consider events that have occurred subsequent to Month XX, 19X6, the date as of which it was filed with the Securities and Exchange Commission.

**.98** If there has been a material subsequent event that has not been disclosed in a manner described in paragraph .96 and if the practitioner determines that it is appropriate to issue a report even though the MD&A presentation has not been updated for such material subsequent event (for example, because the filing of the Form 10-Q that will disclose such events has not yet occurred), the practitioner should express a qualified or an adverse opinion (or appropriately modify the review report) on the MD&A presentation. As discussed in paragraph .108, if such material subsequent event is not appropriately disclosed, the practitioner should evaluate (a) whether to resign from the engagement related to the MD&A presentation and (b) whether to remain as the entity's auditor or stand for reelection to audit the entity's financial statements.

**.99** Because a nonpublic entity is not subject to the filing requirements of the SEC, an MD&A presentation of a nonpublic entity should be updated for material subsequent events through the date of the practitioner's report.

## When a Predecessor Auditor Has Audited Prior Period Financial Statements

**.100** If a predecessor auditor has audited the financial statements for a prior period covered by the MD&A, the need by the practitioner reporting on the MD&A for an understanding of the business and the entity's accounting and financial reporting practices for such prior period, as discussed in paragraph .07, is not diminished and the practitioner should apply the appropriate procedures. In applying the appropriate procedures, the practitioner may consider reviewing the predecessor auditor's working papers with respect to audits of financial statements and examinations or reviews of MD&A presentations for such prior periods.

**.101** Information that may be obtained from the audit or attest working papers of the predecessor auditor will not provide a sufficient basis in itself for the practitioner to express an opinion with respect to the MD&A disclosures for such prior periods. If the practitioner has audited the current year, the results of such audit may be considered in planning and performing the examination of MD&A and may provide evidential matter that is useful in performing the examination, including with respect to matters disclosed for prior periods. For example, an increase in salaries expense may be the result of an acquisition in the last half of the prior year. Auditing procedures applied to payroll expense in the current year that validate the increase as a result of the acquisition may provide evidential matter with respect to the increase in salaries expense in the prior year attributed to the acquisition.

**.102** In addition to the procedures described in paragraphs .50 through .67, the practitioner will need to make inquiries of the predecessor auditor and management as to audit adjustments proposed by the predecessor auditor that were not recorded in the financial statements.



## Communications Between Predecessor and Successor Auditors

.103 If the practitioner is appointed as the successor auditor, he or she follows the guidance in AU section 315, *Communications Between Predecessor and Successor Auditors*, in considering whether or not to accept the engagement. If, at the time of the appointment as auditor, the practitioner is also being engaged to examine or review MD&A, the practitioner should also make specific inquiries of the predecessor auditor regarding MD&A.

.104 The practitioner's examination may be facilitated by (a) making specific inquiries of the predecessor regarding matters that the successor believes may affect the conduct of the examination (or review), such as areas that required an inordinate amount of time or problems that arose from the condition of the records, and (b) if the predecessor previously examined or reviewed MD&A, reviewing the predecessor's working papers for the predecessor's examination or review engagement.

.105 If, subsequent to his or her engagement to audit the financial statements, the practitioner is requested to examine MD&A, the practitioner should request the client to authorize the predecessor auditor to allow a review of the predecessor's audit working papers related to the financial statement periods included in the MD&A presentation. Although the practitioner may previously have had access to the predecessor auditor's working papers in connection with the successor's audit of the financial statements, ordinarily the predecessor auditor should permit the practitioner to review those audit working papers relating to matters that are disclosed or that would likely be disclosed in MD&A.

## When Another Auditor Audits a Significant Part of the Financial Statements

.106 When another auditor or auditors audit a significant part of the financial statements, the practitioner<sup>27</sup> may request that such other auditor or auditors perform procedures with respect to the MD&A or the practitioner may perform the procedures directly with respect to such component(s).<sup>28</sup> Unless the other auditor issues an examination or review report on a separate MD&A presentation of such component(s) (see paragraph .75), the principal practitioner should not make reference to the work of the other practitioner on MD&A in his or her report on MD&A.<sup>29</sup> Accordingly, if the practitioner has requested such other auditor to perform procedures, the principal practitioner should perform those procedures that he or she considers necessary to take responsibility for the work of the other auditor. Such procedures may include one or more of the following:

- a. Visiting the other auditor and discussing the procedures followed and the results thereof
- b. Reviewing the working papers of the other auditor with respect to the component

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<sup>27</sup> The practitioner serving as principal auditor is presumed to have an audit base for purposes of examining or reviewing the consolidated MD&A presentation.

<sup>28</sup> The practitioner should consider whether he or she has sufficient industry expertise with respect to a subsidiary audited by another auditor to take sole responsibility for the consolidated MD&A presentation.

<sup>29</sup> This does not preclude the practitioner from referring to the other auditor's report on the financial statements in his or her report on MD&A.

- c. Participating in discussions with the component's management regarding matters that may affect the preparation of MD&A
- d. Making supplemental tests with respect to such component

The determination of the extent of the procedures to be applied by the principal practitioner rests with the principal practitioner alone in the exercise of his or her professional judgment and in no way constitutes a reflection on the adequacy of the other auditor's work. Because the principal practitioner in this case assumes responsibility for his or her opinion on the MD&A presentation without making reference to the procedures performed by the other auditor, the practitioner's judgment should govern as to the extent of procedures to be undertaken.

## Responsibility for Other Information in Documents Containing MD&A

.107 The guidance in AU section 550, *Other Information in Documents Containing Audited Financial Statements*, is also pertinent to other information in annual reports containing MD&A and other documents to which the practitioner, at the client's request, devotes attention. Accordingly, the practitioner should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the MD&A presentation that has been reported upon by the practitioner. If there is a material inconsistency, the practitioner should determine whether the MD&A, the report on MD&A, or both require revision, and take such actions as described in AU section 550 for audited financial statements. See appendix D [paragraph .118], "Comparison of Activities Performed Under SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*, Versus a Review or an Examination Attest Engagement." The guidance in AU section 711, *Filings Under Federal Securities Statutes*, is pertinent when the practitioner's report on MD&A is included in a registration statement, proxy statement, or periodic report filed under the federal securities statutes.

## Communications With the Audit Committee

.108 If the practitioner concludes that the MD&A presentation contains material inconsistencies with other information included in the document containing the MD&A presentation or with the historical financial statements,<sup>30</sup> material omissions, or material misstatements of fact, and management refuses to take corrective action, the practitioner should inform the audit committee or others with equivalent authority and responsibility. If the MD&A is not revised, the practitioner should evaluate (a) whether to resign from the engagement related to the MD&A, and (b) whether to remain as the entity's auditor or stand for reelection to audit the entity's financial statements. The practitioner may wish to consult with his or her attorney when making these evaluations.

.109 If the practitioner is engaged after the MD&A presentation has been filed with the SEC (or other regulatory agency), and becomes aware that such MD&A presentation on file with the SEC (or other regulatory agency) has not been revised for a matter for which the practitioner has or would qualify his or her opinion, the practitioner should discuss such matter with the audit committee and request that the MD&A presentation be revised. If the audit com-

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<sup>30</sup> See AU section 550 for guidance on the impact of material inconsistencies or material misstatements of fact on the auditor's report on the related historical financial statements.

mittee fails to take appropriate action, the practitioner should consider whether to resign as the independent auditor of the company. The practitioner may consider the guidance concerning communication with the audit committee and other considerations in AU section 317, *Illegal Acts by Clients*, paragraphs .17, .22, and .23.

.110 If, as a result of performing an examination or a review of MD&A, the practitioner has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is generally appropriate even if the matter might be considered clearly inconsequential. If the matter relates to the audited financial statements, the practitioner should consider the guidance in AU section 316, *Consideration of Fraud in a Financial Statement Audit*, concerning communication responsibilities, and the effect on the auditor's report on the financial statements.

## Obtaining Written Representations

.111 In an examination or a review engagement, the practitioner should obtain written representations from management.<sup>31</sup> The specific written representations obtained by the practitioner will depend on the circumstances of the engagement and the nature of the MD&A presentation. Specific representations should relate to the following matters:

- a. Management's acknowledgment of its responsibility for the preparation of MD&A and a statement that management has prepared the MD&A presentation in accordance with the rules and regulations adopted by the SEC for MD&A<sup>32</sup>
- b. A statement that the historical financial amounts included in MD&A have been accurately derived from the entity's financial statements
- c. Management's belief that the underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained in the MD&A
- d. A statement that management has made available all significant documentation related to compliance with SEC rules and regulations for MD&A
- e. Completeness and availability of all minutes of meetings of stockholders, directors, and committees of directors
- f. If a public entity, whether any communications from the SEC were received concerning noncompliance with or deficiencies in MD&A reporting practices
- g. Whether any events occurred subsequent to the latest balance sheet date that would require disclosure in the MD&A
- h. If forward-looking information is included, a statement that—

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<sup>31</sup> AU section 333, *Management 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. AU section 711, *Filings Under Federal Securities Statutes*, paragraph .10, provides guidance concerning obtaining updated representations from management in connection with accountant's reports included or incorporated by reference in filings under the 1933 Act (see paragraph .66).

<sup>32</sup> Management should specify the SEC rules (for example, Item 303 of Regulation S-K, Item 303 of Regulation S-B or Item 9 of Form 20-F). For nonpublic entities, the practitioner also obtains a written assertion that the presentation has been prepared using the rules and regulations adopted by the SEC (see paragraph .02).

- The forward-looking information is based on management's best estimate of expected events and operations, and is consistent with budgets, forecasts, or operating plans prepared for such periods
  - The accounting principles expected to be used for the forward-looking information are consistent with the principles used in preparing the historical financial statements
  - Management has provided the latest version of such budgets, forecasts, or operating plans, and has informed the practitioner of any anticipated changes or modifications to such information that could affect the disclosures contained in the MD&A presentation
- i.* If voluntary information is included that is subject to the rules and regulations adopted by the SEC (for example, information required by Item 305, *Quantitative and Qualitative Disclosures About Market Risk*), a statement that such voluntary information has been prepared in accordance with the related rules and regulations adopted by the SEC for such information
- j.* If pro forma information is included, a statement that—
- Management is responsible for the assumptions used in determining the pro forma adjustments
  - Management believes that the assumptions provide a reasonable basis for presenting all the significant effects directly attributable to the transaction or event, that the related pro forma adjustments give appropriate effect to those assumptions, and that the pro forma column reflects the proper application of those adjustments to the historical financial statements
  - Management believes that the significant effects directly attributable to the transaction or event are appropriately disclosed in the pro forma financial information

.112 In an examination, management's refusal to furnish written representations constitutes a limitation on the scope of the engagement sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause a practitioner to disclaim an opinion or withdraw from the examination engagement. However, based on the nature of the representations not obtained or the circumstances of the refusal, the practitioner may conclude that a qualified opinion is appropriate in an examination engagement. In a review engagement, management's refusal to furnish written representations constitutes a limitation of the scope of the engagement sufficient to require withdrawal from the review engagement. Further, the practitioner should consider the effects of the refusal on his or her ability to rely on other management representations.

.113 If the practitioner is precluded from performing procedures he or she considers necessary in the circumstances with respect to a matter that is material to the MD&A presentation, even though management has given representations concerning the matter, there is a limitation on the scope of the engagement, and the practitioner should qualify his or her opinion or disclaim an opinion in an examination engagement, or withdraw from a review engagement.

## Effective Date

.114 This section is effective upon issuance.

.115

## Appendix A

### Examination Reports

#### Example 1: Standard Examination Report

1. The following is an illustration of a standard examination report:

#### Independent Accountant's Report

##### *[Introductory paragraph]*

We have examined XYZ Company's Management's Discussion and Analysis taken as a whole, included *[incorporated by reference]* in the Company's *[insert description of registration statement or document]*. Management is responsible for the preparation of the Company's Management's Discussion and Analysis pursuant to the rules and regulations adopted by the Securities and Exchange Commission. Our responsibility is to express an opinion on the presentation based on our examination. We have audited, in accordance with generally accepted auditing standards, the financial statements of XYZ Company as of December 31, 19X5 and 19X4, and for each of the years in the three-year period ended December 31, 19X5, and in our report dated Month XX, 19X6, we expressed an unqualified opinion on those financial statements.<sup>33</sup>

##### *[Scope paragraph]*

Our examination of Management's Discussion and Analysis was made in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting the historical amounts and disclosures in the presentation. An examination also includes assessing the significant determinations made by management as to the relevancy of information to be included and the estimates and assumptions that affect reported information. We believe that our examination provides a reasonable basis for our opinion.

##### *[Explanatory paragraph]*<sup>34</sup>

The preparation of Management's Discussion and Analysis requires management to interpret the criteria, make determinations as to the relevancy of in-

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<sup>33</sup> If prior financial statements were audited by other auditors, this sentence would be replaced by the following:

We have audited, in accordance with generally accepted auditing standards, the financial statements of XYZ Company as of and for the year ended December 31, 19X5, and in our report dated Month XX, 19X6, we expressed an unqualified opinion on those financial statements. The financial statements of XYZ Company as of December 31, 19X4, and for each of the years in the two-year period then ended were audited by other auditors, whose report dated Month XX, 19X5, expressed an unqualified opinion on those financial statements.

If the practitioner's opinion on the financial statements is based on the report of other auditors, this sentence would be replaced by the following:

We have audited, in accordance with generally accepted auditing standards, the financial statements of XYZ Company as of December 31, 19X5 and 19X4, and for each of the years in the three-year period ended December 31, 19X5, and in our report dated Month XX, 19X6, we expressed an unqualified opinion on those financial statements based on our audits and the report of other auditors.

Refer to Example 3 if the practitioner's opinion on MD&A is based on the report of another practitioner on a component of the entity.

<sup>34</sup> The following sentence should be added to the beginning of the explanatory paragraph if the entity is a nonpublic entity, as discussed in paragraph .70h:

Although XYZ Company is not subject to the rules and regulations of the Securities and Exchange Commission, the accompanying Management's Discussion and Analysis is intended to be a presentation in accordance with the rules and regulations adopted by the Securities and Exchange Commission.

formation to be included, and make estimates and assumptions that affect reported information. Management's Discussion and Analysis includes information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties. Actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

*[Opinion paragraph]*

In our opinion, the Company's presentation of Management's Discussion and Analysis includes, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission; the historical financial amounts included therein have been accurately derived, in all material respects, from the Company's financial statements; and the underlying information, determinations, estimates, and assumptions of the Company provide a reasonable basis for the disclosures contained therein.

*[Signature]*

*[Date]*

### **Example 2: Modifications to Examination Report for a Qualified Opinion**

2. An example of a modification of an examination report for a qualified opinion due to a material omission described in paragraph .73 follows:

*[Additional explanatory paragraph preceding the opinion paragraph]*

Based on information furnished to us by management, we believe that the Company has excluded a discussion of the significant capital outlay required for its plans to expand into the telecommunications industry and the possible effects on the Company's financial condition, liquidity, and capital resources.

*[Opinion paragraph]*

In our opinion, except for the omission of the matter described in the preceding paragraph, the Company's presentation of Management's Discussion and Analysis includes, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission; the historical financial amounts included therein have been accurately derived, in all material respects, from the Company's financial statements; and the underlying information, determinations, estimates, and assumptions of the Company provide a reasonable basis for the disclosures contained therein.

3. An example of a modification of an examination report for a qualified opinion when overly subjective assertions are included in MD&A follows:

*[Additional explanatory paragraph preceding the opinion paragraph]*

Based on information furnished to us by management, we believe that the underlying information, determinations, estimates, and assumptions used by management do not provide the Company with a reasonable basis for the disclosure concerning *[describe]* in the Company's Management's Discussion and Analysis.

*[Opinion paragraph]*

In our opinion, except for the disclosure regarding *[describe]* discussed in the preceding paragraph, the Company's presentation of Management's Discussion and Analysis includes, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission; the historical financial amounts included therein have been accurately derived, in

all material respects, from the Company's financial statements; and the underlying information, determinations, estimates, and assumptions of the Company provide a reasonable basis for the disclosures contained therein.

### **Example 3: Examination Report With Reference to the Report of Another Practitioner**

4. The following is an illustration of an examination report indicating a division of responsibility with another practitioner, who has examined a separate MD&A presentation of a wholly-owned subsidiary, when the practitioner reporting is serving as the principal auditor of the related consolidated financial statements:

#### Independent Accountant's Report

##### *[Introductory paragraphs]*

We have examined XYZ Company's Management's Discussion and Analysis taken as a whole, included *[incorporated by reference]* in the Company's *[insert description of registration statement or document]*. Management is responsible for the preparation of the Company's Management's Discussion and Analysis pursuant to the rules and regulations adopted by the Securities and Exchange Commission. Our responsibility is to express an opinion on the presentation based on our examination. We did not examine Management's Discussion and Analysis of ABC Corporation, a wholly-owned subsidiary, included in ABC Corporation's *[insert description of registration statement or document]*. Such Management's Discussion and Analysis was examined by other accountants, whose report has been furnished to us, and our opinion, insofar as it relates to information included for ABC Corporation, is based solely on the report of the other accountants.

We have audited, in accordance with generally accepted auditing standards, the consolidated financial statements of XYZ Company as of December 31, 19X5 and 19X4, and for each of the years in the three-year period ended December 31, 19X5, and in our report dated Month XX, 19X6, we expressed an unqualified opinion on those financial statements based on our audits and the report of other auditors.

##### *[Scope paragraph]*

Our examination of Management's Discussion and Analysis was made in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting the historical amounts and disclosures in the presentation. An examination also includes assessing the significant determinations made by management as to the relevancy of information to be included and the estimates and assumptions that affect reported information. We believe that our examination and the report of other accountants provide a reasonable basis for our opinion.

##### *[Explanatory paragraph]<sup>35</sup>*

The preparation of Management's Discussion and Analysis requires management to interpret the criteria, make determinations as to the relevancy of in-

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<sup>35</sup> The following sentence should be added to the beginning of the explanatory paragraph if the entity is a nonpublic entity, as discussed in paragraph .70h:

Although XYZ Company is not subject to the rules and regulations of the Securities and Exchange Commission, the accompanying Management's Discussion and Analysis is intended to be a presentation in accordance with the rules and regulations adopted by the Securities and Exchange Commission.

formation to be included, and make estimates and assumptions that affect reported information. Management's Discussion and Analysis includes information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties. Actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

[*Opinion paragraph*]

In our opinion, based on our examination and the report of other accountants, the Company's presentation of Management's Discussion and Analysis included [*incorporated by reference*] in the Company's [*insert description of registration statement or document*] includes, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission; the historical financial amounts included therein have been accurately derived, in all material respects, from the Company's financial statements; and the underlying information, determinations, estimates, and assumptions of the Company provide a reasonable basis for the disclosures contained therein.

[*Signature*]

[*Date*]



.116

## Appendix B

### Review Reports

#### **Example 1: Standard Review Report on an Annual MD&A Presentation**

1. The following is an illustration of a standard review report on an annual MD&A presentation:

#### Independent Accountant's Report

##### *[Introductory paragraph]*

We have reviewed XYZ Company's Management's Discussion and Analysis taken as a whole, included *[incorporated by reference]* in the Company's *[insert description of registration statement or document]*. Management is responsible for the preparation of the Company's Management's Discussion and Analysis pursuant to the rules and regulations adopted by the Securities and Exchange Commission. We have audited, in accordance with generally accepted auditing standards, the financial statements of XYZ Company as of December 31, 19X5 and 19X4, and for each of the years in the three-year period ended December 31, 19X5, and in our report dated Month XX, 19X6, we expressed an unqualified opinion on those financial statements.

##### *[Scope paragraph]*

We conducted our review of Management's Discussion and Analysis in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review of Management's Discussion and Analysis consists principally of applying analytical procedures and making inquiries of persons responsible for financial, accounting, and operational matters. It is substantially less in scope than an examination, the objective of which is the expression of an opinion on the presentation. Accordingly, we do not express such an opinion.

##### *[Explanatory paragraph]<sup>36</sup>*

The preparation of Management's Discussion and Analysis requires management to interpret the criteria, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information. Management's Discussion and Analysis includes information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties. Actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

##### *[Concluding paragraph]*

Based on our review, nothing came to our attention that caused us to believe that the Company's presentation of Management's Discussion and Analysis

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<sup>36</sup> The following sentence should be added to the beginning of the explanatory paragraph if the entity is a nonpublic entity, as discussed in paragraph .86i:

Although XYZ Company is not subject to the rules and regulations of the Securities and Exchange Commission, the accompanying Management's Discussion and Analysis is intended to be a presentation in accordance with the rules and regulations adopted by the Securities and Exchange Commission.

does not include, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission, that the historical financial amounts included therein have not been accurately derived, in all material respects, from the Company's financial statements, or that the underlying information, determinations, estimates and assumptions of the Company do not provide a reasonable basis for the disclosures contained therein.

[*Restricted use paragraph*]<sup>37</sup>

This report is intended solely for the information and use of [*the specified parties*],<sup>38</sup> and is not intended to be, and should not be, used by anyone other than the specified parties.

[*Signature*]

[*Date*]

### **Example 2: Standard Review Report on an Interim MD&A Presentation**

2. The following is an illustration of a standard review report on an MD&A presentation for an interim period:

#### Independent Accountant's Report

[*Introductory paragraph*]

We have reviewed XYZ Company's Management's Discussion and Analysis taken as a whole included in the Company's [*insert description of registration statement or document*]. Management is responsible for the preparation of the Company's Management's Discussion and Analysis pursuant to the rules and regulations adopted by the Securities and Exchange Commission. We have reviewed, in accordance with standards established by the American Institute of Certified Public Accountants, the interim financial information of XYZ Company as of June 30, 19X6 and 19X5, and for the three-month and six-month periods then ended, and have issued our report thereon dated July XX, 19X6.

[*Scope paragraph*]

We conducted our review of Management's Discussion and Analysis in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review of Management's Discussion and Analysis consists principally of applying analytical procedures and making inquiries of persons responsible for financial, accounting, and operational matters. It is substantially less in scope than an examination, the objective of which is the expression of an opinion on the presentation. Accordingly, we do not express such an opinion.

[*Explanatory paragraph*]<sup>39</sup>

The preparation of Management's Discussion and Analysis requires management to interpret the criteria, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect

<sup>37</sup> This paragraph may be omitted for certain nonpublic entities (refer to paragraph .86*k*).

<sup>38</sup> The report should list the specified parties.

<sup>39</sup> The following sentence should be added to the beginning of the explanatory paragraph if the entity is a nonpublic entity, as discussed in paragraph .86*i*:

Although XYZ Company is not subject to the rules and regulations of the Securities and Exchange Commission, the accompanying Management's Discussion and Analysis is intended to be a presentation in accordance with the rules and regulations adopted by the Securities and Exchange Commission.

reported information. Management's Discussion and Analysis includes information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties. Actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

*[Concluding paragraph]*

Based on our review, nothing came to our attention that caused us to believe that the Company's presentation of Management's Discussion and Analysis does not include, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission, that the historical financial amounts included therein have not been accurately derived, in all material respects, from the Company's financial statements, or that the underlying information, determinations, estimates, and assumptions of the Company do not provide a reasonable basis for the disclosures contained therein.

*[Restricted use paragraph]*<sup>40</sup>

This report is intended solely for the information and use of *[the specified parties]*,<sup>41</sup> and is not intended to be, and should not be, used by anyone other than the specified parties.

*[Signature]*

*[Date]*

### **Example 3: Modification to Review Report for a Material Misstatement**

3. An example of a modification of the accountant's report when MD&A is materially misstated, as discussed in paragraph .90, follows:

*[Additional explanatory paragraph preceding the concluding paragraph]*

Based on information furnished to us by management, we believe that the Company has excluded a discussion of the significant capital outlay required for its plans to expand into the telecommunications industry and the possible effects on the Company's financial condition, liquidity, and capital resources.

*[Concluding paragraph]*

Based on our review, with the exception of the matter described in the preceding paragraph, nothing came to our attention that caused us to believe that the Company's presentation of Management's Discussion and Analysis does not include, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission, that the historical financial amounts included therein have not been accurately derived, in all material respects, from the Company's financial statements, or that the underlying information, determinations, estimates and assumptions of the Company do not provide a reasonable basis for the disclosures contained therein.

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<sup>40</sup> This paragraph may be omitted for certain nonpublic entities (refer to paragraph .86k).

<sup>41</sup> This report should list the specified parties.

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## Appendix C

### Combined Reports

#### **Example 1: Combined Examination and Review Report on MD&A**

1. An example of a combined report on an examination of an annual MD&A presentation and the review of MD&A for an interim period discussed in paragraph .93 follows:

##### Independent Accountant's Report

###### *[Introductory paragraph]*

We have examined XYZ Company's Management's Discussion and Analysis taken as a whole for the three-year period ended December 31, 19X5, included [incorporated by reference] in the Company's [insert description of registration statement or document]. Management is responsible for the preparation of the Company's Management's Discussion and Analysis pursuant to the rules and regulations adopted by the Securities and Exchange Commission. Our responsibility is to express an opinion on the annual presentation based on our examination. We have audited, in accordance with generally accepted auditing standards, the financial statements of XYZ Company as of December 31, 19X5 and 19X4, and for each of the years in the three-year period ended December 31, 19X5, and in our report dated Month XX, 19X6, we expressed an unqualified opinion on those financial statements.

###### *[Scope paragraph]*

Our examination of Management's Discussion and Analysis was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting the historical amounts and disclosures in the presentation. An examination also includes assessing the significant determinations made by management as to the relevancy of information to be included and the estimates and assumptions that affect reported information. We believe that our examination provides a reasonable basis for our opinion.

###### *[Explanatory paragraph]<sup>42</sup>*

The preparation of Management's Discussion and Analysis requires management to interpret the criteria, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information. Management's Discussion and Analysis includes information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties. Actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

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<sup>42</sup> The following sentence should be added to the beginning of the explanatory paragraph if the entity is a nonpublic entity, as discussed in paragraph .70a:

Although XYZ Company is not subject to the rules and regulations of the Securities and Exchange Commission, the accompanying Management's Discussion and Analysis is intended to be a presentation in accordance with the rules and regulations adopted by the Securities and Exchange Commission.

[*Opinion paragraph*]

In our opinion, the Company's presentation of Management's Discussion and Analysis for the three-year period ended December 31, 19X5, includes, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission; the historical financial amounts included therein have been accurately derived, in all material respects, from the Company's financial statements; and the underlying information, determinations, estimates, and assumptions of the Company provide a reasonable basis for the disclosures contained therein.

[*Paragraphs on interims*]

We have also reviewed XYZ Company's Management's Discussion and Analysis taken as a whole for the six-month period ended June 30, 19X6 included [*incorporated by reference*] in the Company's [*insert description of registration statement or document*]. We have reviewed, in accordance with standards established by the American Institute of Certified Public Accountants, the interim financial information of XYZ Company as of June 30, 19X6 and 19X5, and for the six-month periods then ended, and have issued our report thereon dated July XX, 19X6.

We conducted our review of Management's Discussion and Analysis in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review of Management's Discussion and Analysis consists principally of applying analytical procedures and making inquiries of persons responsible for financial, accounting, and operational matters. It is substantially less in scope than an examination, the objective of which is the expression of an opinion on the presentation. Accordingly, we do not express such an opinion.

Based on our review, nothing came to our attention that caused us to believe that the Company's presentation of Management's Discussion and Analysis for the six-month period ended June 30, 19X6, does not include, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission, that the historical financial amounts included therein have not been accurately derived, in all material respects, from the Company's unaudited interim financial statements, or that the underlying information, determinations, estimates, and assumptions of the Company do not provide a reasonable basis for the disclosures contained therein.

[*Restricted use paragraph*]<sup>43</sup>

This report is intended solely for the information and use of [*the specified parties*],<sup>44</sup> and is not intended to be, and should not be, used by anyone other than the specified parties.

[*Signature*]

[*Date*]

### **Example 2: Review Report on a Combined Annual and Interim MD&A Presentation**

2. An example of a review report on a combined MD&A presentation for annual and interim periods follows:

Independent Accountant's Report

[*Introductory paragraph*]

We have reviewed XYZ Company's Management's Discussion and Analysis taken as a whole included [*incorporated by reference*] in the Company's [*insert*

<sup>43</sup> This paragraph may be omitted for certain nonpublic entities (refer to paragraph .86f).

<sup>44</sup> The report should list the specified parties.

*description of registration statement or document*]. Management is responsible for the preparation of the Company's Management's Discussion and Analysis pursuant to the rules and regulations adopted by the Securities and Exchange Commission. We have audited, in accordance with generally accepted auditing standards, the financial statements of XYZ Company as of December 31, 19X5 and 19X4, and for each of the years in the three-year period ended December 31, 19X5, and in our report dated Month XX, 19X6, we expressed an unqualified opinion on those financial statements. We have reviewed, in accordance with standards established by the American Institute of Certified Public Accountants, the interim financial information of XYZ Company as of June 30, 19X6 and 19X5, and for the six-month periods then ended, and have issued our report thereon dated July XX, 19X6.

[*Scope paragraph*]

We conducted our review of Management's Discussion and Analysis in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review of Management's Discussion and Analysis consists principally of applying analytical procedures and making inquiries of persons responsible for financial, accounting, and operational matters. It is substantially less in scope than an examination, the objective of which is the expression of an opinion on the presentation. Accordingly, we do not express such an opinion.

[*Explanatory paragraph*]<sup>45</sup>

The preparation of Management's Discussion and Analysis requires management to interpret the criteria, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information. Management's Discussion and Analysis includes information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties. Actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

[*Concluding paragraph*]

Based on our review, nothing came to our attention that caused us to believe that the Company's presentation of Management's Discussion and Analysis does not include, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission, that the historical financial amounts included therein have not been accurately derived, in all material respects, from the Company's financial statements, or that the underlying information, determinations, estimates, and assumptions of the Company do not provide a reasonable basis for the disclosures contained therein.

[*Restricted use paragraph*]<sup>46</sup>

This report is intended solely for the information and use of [*the specified parties*],<sup>47</sup> and is not intended to be, and should not be, used by anyone other than the specified parties.

[*Signature*]

[*Date*]

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<sup>45</sup> The following sentence should be added to the beginning of the explanatory paragraph if the entity is a nonpublic entity, as discussed in paragraph 70h:

Although XYZ Company is not subject to the rules and regulations of the Securities and Exchange Commission, the accompanying Management's Discussion and Analysis is intended to be a presentation in accordance with the rules and regulations adopted by the Securities and Exchange Commission.

<sup>46</sup> This paragraph may be omitted for certain nonpublic entities (refer to paragraph .86k).

<sup>47</sup> The report should list the specified parties.

**Appendix D**

**Comparison of Activities Performed Under SAS No. 8, Other Information in Documents Containing Audited Financial Statements [AU section 550], Versus a Review or an Examination Attest Engagement**

<i>Activities</i>	<i>SAS No. 8</i>	<i>Review</i>	<i>Examination</i>
<p>Obtain an understanding of SEC rules and regulations and management's methodology for the preparation of MD&amp;A.</p>	<p>Not applicable (N/A)—Auditor is only required to read the information in the MD&amp;A and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.</p>	<p>Obtain an understanding of the rules and regulations adopted by the SEC for MD&amp;A.  Inquire of management regarding the method of preparing MD&amp;A.</p>	<p>Same as for a review.</p>
<p>Plan the engagement.</p>	<p>N/A</p>	<p>Develop an overall strategy for the analytical procedures and inquiries to be performed to provide negative assurance.</p>	<p>Develop an overall strategy for the expected scope and performance of the engagement to obtain reasonable assurance to express an opinion.</p>
<p>Consider internal control.</p>	<p>N/A</p>	<p>Consider relevant portions of the entity's internal control applicable to the preparation of MD&amp;A to identify types of potential misstatements and to select the inquiries and analytical procedures; no testing of controls would be performed.</p>	<p>Obtain an understanding of internal control applicable to the preparation of MD&amp;A sufficient to plan the engagement and to assess control risk; controls may be tested by performing inquiries of client personnel, inspection of documents, and observation of relevant activities.</p>

(continued)

\* Refer to AU section 550, Other Information in Documents Containing Audited Financial Statements.

<i>Activities</i>	<i>SAS No. 8</i>	<i>Review</i>	<i>Examination</i>
<p>Test assertions.</p>	<p>N/A</p>	<p>Apply the following analytical procedures and make inquiries of management and others; no corroborating evidential matter is obtained:</p> <ul style="list-style-type: none"> <li>• Read the MD&amp;A and compare the content for consistency with the financial statements; compare financial amounts to the financial statements or related accounting records and analyses; recompute increases, decreases and percentages disclosed.</li> <li>• Compare nonfinancial amounts to the financial statements or other records.</li> <li>• Consider whether MD&amp;A explanations are consistent with information obtained during the audit or review of financial statements; make further inquiries, as necessary. (<i>Note:</i> Such additional inquiries may result in a decision to perform other procedures or detail tests.)</li> </ul>	<p>Apply the following analytical and corroborative procedures to obtain reasonable assurance of detecting material misstatements:</p> <ul style="list-style-type: none"> <li>• Read the MD&amp;A and compare the content for consistency with the financial statements; compare financial amounts to the financial statements or related accounting records and analyses; recompute increases, decreases and percentages disclosed.</li> <li>• Compare nonfinancial amounts to the financial statements or other records; perform tests on other records based on the concept of materiality.</li> <li>• Consider whether explanations are consistent with information obtained during the audit of financial statements; investigate further explanations that cannot be substantiated by information in the audit working papers through inquiry and inspection of client records.</li> <li>• Examine internally and externally generated documents in support of the existence, occurrence, or expected occurrence of events, transactions, conditions, trends, demands, commitments, and uncertainties disclosed in MD&amp;A.</li> </ul>



Test assertions.  
(continued)

- Compare information in MD&A with the rules and regulations adopted by the SEC.
- Obtain and read available prospective financial information; inquire of management as to the procedures used to prepare such information; consider whether information came to the practitioner's attention that causes him or her to believe that the underlying information, determinations, estimates and assumptions do not provide a reasonable basis for the MD&A disclosures.
- Obtain public communications and minutes of meetings for comparison with disclosures in MD&A.
- Make inquiries of the officers or executives with responsibility for operational areas and financial and accounting matters as to their plans and expectations for the future.
- Inquire as to prior experience with the SEC and the extent of comments received; read correspondence.
- Consider whether there are any additional matters that should be disclosed in the MD&A based on the results of the preceding procedures and knowledge obtained during the audit or review of the financial statements.

- Compare information in MD&A with the rules and regulations adopted by the SEC.
- Obtain and read available prospective financial information; inquire of management as to the procedures used to prepare such information; evaluate whether the underlying information, determinations, estimates, and assumptions provide a reasonable basis for the MD&A disclosures.
- Obtain public communications and minutes of meetings; consider obtaining other types of publicly available information for comparison with disclosures in MD&A.
- Make inquiries of the officers or executives with responsibility for operational areas and financial and accounting matters as to their plans and expectations for the future.
- Inquire as to prior experience with the SEC and the extent of comments received; read correspondence.
- Test completeness by considering the results of the preceding procedures and knowledge obtained during the audit of the financial statements, and whether such matters are appropriately disclosed in the MD&A; extend procedures if the inherent risk relating to completeness of disclosures is high.

(continued)

<i>Activities</i>	<i>SAS No. 8</i>	<i>Review</i>	<i>Examination</i>
Consider the effect of events subsequent to the balance-sheet date.	N/A	Yes	Yes
Obtain written representations from management.	N/A	Yes	Yes
Form a conclusion and report.	<p>The auditor has no reporting responsibility with respect to MD&amp;A unless the auditor concludes that there is a material inconsistency in the MD&amp;A that has not been eliminated. In such a situation, the auditor may add an explanatory paragraph concerning the inconsistency to the auditor's report on the financial statements or withhold the use of the report in the document.</p> <p>If, while reading the MD&amp;A, the auditor becomes aware of information that is believed to be a material misstatement of fact, the auditor should discuss such matter with the client.</p>	Form a conclusion based on the results of the preceding procedures and report in the form of negative assurance.	Form an opinion based on the results of the preceding procedures and report conclusion by expressing an opinion.

[The next page is 2961.]

## AT Section 9700

# Management's Discussion and Analysis: Attestation Engagements Interpretations of Section 700

### 1. Consideration of the Year 2000 Issue When Examining or Reviewing Management's Discussion and Analysis

**.01 Introduction**—Many computerized systems, including both hardware and software applications, use only two digits, rather than four, to record the year in a date field. These systems may recognize the year 2000, which is entered into the computer as "00," as the year 1900 or some other date, resulting in errors when the dates are used in computations and comparisons. In addition, some computerized systems do not properly perform calculations with dates beginning in 1999 because these systems use the digits "99" in date fields to represent something other than the year 1999. Such problems are known as the Year 2000 Issue. The Year 2000 Issue may manifest itself before, on, or after January 1, 2000, and the effect on operations and financial reporting may range from minor errors to catastrophic systems failure.

**.02** Because many entities rely on computer systems and exchange information electronically with other entities, the Year 2000 Issue is expected to affect entities in a variety of industries, governmental entities, and not-for-profit organizations. Entities will need to consider ways of addressing the possible effects of the Year 2000 Issue, including the need to remediate or replace, and test, a large number of programs and hardware in a very limited period of time. The Year 2000 Issue can affect computer systems used for a variety of applications by an entity, including accounting, management information, and operational control applications and equipment functional applications.

**.03 Question**—The Securities and Exchange Commission (SEC) Interpretive Release titled *Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers*<sup>1</sup> requires disclosures in management's discussion and analysis (MD&A) concerning year 2000 matters in certain circumstances. The SEC staff expects those disclosures to address the following four categories of information:

- The company's state of readiness
- The costs to address the year 2000 issues
- The risks of the company's year 2000 issues, and
- The company's contingency plans

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<sup>1</sup> The SEC staff from time to time issues guidance related to the SEC's adopted requirements (for example, Staff Accounting Bulletins, Staff Legal Bulletins, interpretive releases, and speeches). Although such guidance may provide additional information with respect to the adopted requirements for MD&A, the practitioner should not be expected to attest to assertions on compliance with such guidance. The practitioner may find it helpful to also familiarize himself or herself with material contained on the SEC's Web site that provides further information with respect to the SEC's views concerning MD&A disclosures.

In an examination or a review of MD&A conducted in accordance with section 700, *Management's Discussion and Analysis*, what is the practitioner's responsibility with respect to year 2000 disclosures?

**.04 Interpretation**—Section 700.05 states that “the practitioner’s objective in an engagement to examine MD&A is to express an opinion on the MD&A presentation taken as a whole by reporting whether (a) the presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC, (b) the historical financial amounts have been accurately derived, in all material respects, from the entity’s financial statements, and (c) the underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained therein.” Section 700.08 states that “the objective of a review of MD&A is to report whether any information came to the practitioner’s attention to cause him or her to believe that (a) the MD&A presentation does not include, in all material respects, the required elements of the rules and regulations adopted by the SEC, (b) the historical financial amounts included therein have not been accurately derived, in all material respects, from the entity’s financial statements, or (c) the underlying information, determinations, estimates, and assumptions of the entity do not provide a reasonable basis for the disclosures contained therein.”

**.05** In expressing an opinion on MD&A or providing the limited assurance in a review report, the practitioner is not reporting specifically on the year 2000 disclosures; rather, he or she is considering whether such disclosures, in conjunction with all other disclosures, have been accurately derived, in all material respects, from the entity’s financial statements and whether the underlying information, determinations, estimates, and assumptions provide a reasonable basis for the disclosures contained therein. The practitioner performing an examination or review of MD&A considers year 2000 disclosures, as other disclosures, in relation to the MD&A taken as a whole, and is not required to apply the procedures necessary to express a separate opinion on the year 2000 disclosures.

**.06** Ordinarily, it is not possible for management or the practitioner to conclude that an entity is or will be year 2000 compliant. As noted by the SEC in a 1997 *Report to the Congress on the Readiness of the United States Securities Industry and Public Companies to Meet the Information Processing Challenges of the Year 2000*—

[i]t is not, and will not, be possible for any single entity or collective enterprise to represent that it has achieved complete Year 2000 compliance and thus to guarantee its remediation efforts. The problem is simply too complex for such a claim to have legitimacy. Efforts to solve Year 2000 problems are best described as “risk mitigation.” Success in the effort will have been achieved if the number and seriousness of any technical failures is minimized, and they are quickly identified and repaired if they do occur.

Accordingly, an examination or review of MD&A in accordance with section 700 does not provide assurance that an entity is or will be year 2000 compliant. Additionally, an examination or review does not provide assurance as to the current or future year 2000 compliance of parties with which the entity does business.

**.07** Section 700.70 and .84 require the practitioner’s report to contain a paragraph stating, in part, that—

[a]ctual results in the future may differ materially from management’s present assessment of information regarding the estimated future impact of transactions

and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties.

The Year 2000 Issue is an event contemplated by this paragraph of the practitioner's report.

**.08 Question**—When performing an examination, how might the practitioner test year 2000 disclosures in MD&A?

**.09 Interpretation**—The practitioner should consider whether the effects of the Year 2000 Issue should be disclosed in MD&A and, if so, whether they are disclosed. Tests of disclosures will depend on the nature of the disclosures. For example, the practitioner may test amounts expended to date by comparison with records underlying the financial statements or, for total estimated cost, he or she may compare such amounts with budgets, business plans, or the entity's year 2000 remediation plan.

**.10** If the entity chooses to make disclosures about the state of year 2000 readiness or management's view of whether the entity will be compliant by the year 2000, the practitioner's procedures would ordinarily be limited, for the reasons discussed in paragraph .06 of this Interpretation, to considering the process used by management to address the adverse effects of the Year 2000 Issue and the progress of the entity's remediation effort by considering whether internal reports on the process and progress provide a reasonable basis for the disclosures. Procedures include inquiries, reading reports about year 2000 remediation efforts, and reading documentation of monitoring activities. When considering management's process and progress, it is not necessary for the practitioner to independently test whether systems are year 2000 compliant.

**.11** A practitioner's consideration of elements of management's process and progress with respect to the Year 2000 Issue may require specialized skill or knowledge about computer hardware and software and information technology that a practitioner is not expected to have. Section 700.48 indicates that specialized skill or knowledge may be required to test some complex or subjective matters. In such cases, the practitioner may use the work of a specialist and should consider the guidance in AU section 336, *Using the Work of a Specialist*.

**.12** When evaluating the qualifications of the specialist pursuant to AU section 336.08, the practitioner should consider whether the specialist possesses the necessary skill or knowledge. Although specialists do not have professional certifications in year 2000 compliance matters and have not been able to fully demonstrate their ability to address the Year 2000 Issue due to its unprecedented and prospective nature, the practitioner may consider such factors as experience with systems enhancements, upgrades and replacements, large scale systems project management, and past record of success and timeliness of completion when evaluating the specialist's professional qualifications.

**.13** Management may have engaged or employed specialists to develop and implement a year 2000 remediation plan. A year 2000 remediation plan may require the participation of more than one specialist. As a result of the extent of the effort required to address the Year 2000 Issue by many entities, there may be a shortage of available qualified specialists. Accordingly, if a practitioner decides to use the work of a specialist, it is likely that it will be a specialist engaged or employed by the entity, rather than a specialist engaged by the practitioner. When specialists engaged or employed by the entity have developed or are implementing significant aspects of the year 2000 remediation plan, the practitioner should consider the guidance in AU section 336.10 and .11.

.14 *Question*—How would the practitioner's approach to year 2000 disclosures differ if a review is being performed?

.15 *Interpretation*—Procedures for conducting a review generally are limited to inquiries and analytical procedures.<sup>2</sup> Accordingly, the review procedures to test year 2000 disclosures will generally be limited to inquiries since analytical procedures generally would not apply to year 2000 disclosures.

.16 *Question*—Section 700.111 requires the practitioner to obtain written representations from management concerning MD&A. What written representations might the practitioner obtain concerning year 2000 disclosures to supplement other procedures?

.17 *Interpretation*—The practitioner might obtain written representations about particular disclosures, particularly those that involve management's intent or belief about future events.

[Issue Date: August, 1998; Revised: February, 1999.]

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[The next page is 2971.]

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<sup>2</sup> See section 700.77 and .80 through .82.

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