AICPA audit and accounting manual as of June 1, 2009: nonauthoritative technical practice aid

American Institute of Certified Public Accountants

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AICPA Audit and Accounting Manual

As of June 1, 2009

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# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>. . .</td>
<td>How to Use This Reporter</td>
<td>1</td>
</tr>
<tr>
<td>AAM 1000</td>
<td>Introduction</td>
<td>1001</td>
</tr>
<tr>
<td>1100</td>
<td>Introduction</td>
<td></td>
</tr>
<tr>
<td>1200</td>
<td>How to Use the Audit and Accounting Manual</td>
<td></td>
</tr>
<tr>
<td>AAM 2000</td>
<td>Compilation and Review</td>
<td>2001</td>
</tr>
<tr>
<td>2100</td>
<td>Introduction</td>
<td></td>
</tr>
<tr>
<td>2200</td>
<td>Engagement Planning and Administration</td>
<td></td>
</tr>
<tr>
<td>2300</td>
<td>Compilation Engagements</td>
<td></td>
</tr>
<tr>
<td>2400</td>
<td>Review Engagements</td>
<td></td>
</tr>
<tr>
<td>2500</td>
<td>Form and Content of Financial Statements</td>
<td></td>
</tr>
<tr>
<td>2600</td>
<td>Reporting</td>
<td></td>
</tr>
<tr>
<td>2610</td>
<td>Accountants’ Reports on Compilation of Financial Statements of a Nonissuer</td>
<td></td>
</tr>
<tr>
<td>2620</td>
<td>Accountants’ Reports on Review of Financial Statements of a Nonissuer</td>
<td></td>
</tr>
<tr>
<td>2700</td>
<td>Special Areas</td>
<td></td>
</tr>
<tr>
<td>2710</td>
<td>Accountants’ Reports on Prescribed Forms, Specified Elements, Personal Financial Statements, and OCBOA Financial Statements</td>
<td></td>
</tr>
<tr>
<td>AAM 3000</td>
<td>Engagement Planning and Administration</td>
<td>3001</td>
</tr>
<tr>
<td>3100</td>
<td>Planning the Engagement</td>
<td></td>
</tr>
<tr>
<td>3105</td>
<td>Understanding the Assignment</td>
<td></td>
</tr>
<tr>
<td>3110</td>
<td>Assigning Personnel to the Engagement and Supervision</td>
<td></td>
</tr>
<tr>
<td>3115</td>
<td>Independence</td>
<td></td>
</tr>
<tr>
<td>3120</td>
<td>Understanding the Entity and Its Environment</td>
<td></td>
</tr>
<tr>
<td>3125</td>
<td>Understanding of Internal Control</td>
<td></td>
</tr>
<tr>
<td>3130</td>
<td>Assessing the Risks of Material Misstatement</td>
<td></td>
</tr>
<tr>
<td>3140</td>
<td>Audit Risk and Materiality</td>
<td></td>
</tr>
<tr>
<td>3145</td>
<td>Fraud</td>
<td></td>
</tr>
<tr>
<td>3150</td>
<td>Illegal Acts</td>
<td></td>
</tr>
<tr>
<td>3155</td>
<td>Analytical Procedures</td>
<td></td>
</tr>
<tr>
<td>3160</td>
<td>Audit Assignment Controls</td>
<td></td>
</tr>
<tr>
<td>3165</td>
<td>Sample Engagement Letters</td>
<td></td>
</tr>
<tr>
<td>AAM 4000</td>
<td>Internal Control</td>
<td>4001</td>
</tr>
<tr>
<td>4100</td>
<td>Introduction</td>
<td></td>
</tr>
<tr>
<td>4200</td>
<td>Internal Control Framework</td>
<td></td>
</tr>
<tr>
<td>AAM 5000</td>
<td>Designing and Performing Further Audit Procedures</td>
<td>5001</td>
</tr>
<tr>
<td>5100</td>
<td>Designing Further Audit Procedures</td>
<td></td>
</tr>
<tr>
<td>5200</td>
<td>Performing Tests of Controls</td>
<td></td>
</tr>
<tr>
<td>5300</td>
<td>Performing Substantive Procedures</td>
<td></td>
</tr>
<tr>
<td>5400</td>
<td>Audit Sampling Considerations</td>
<td></td>
</tr>
<tr>
<td>5500</td>
<td>Suggested Supplemental Reference Materials</td>
<td></td>
</tr>
<tr>
<td>Section</td>
<td>Audit Documentation</td>
<td>Page</td>
</tr>
<tr>
<td>---------</td>
<td>-----------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>AAM 6000</td>
<td>Audit Documentation—General</td>
<td>6001</td>
</tr>
<tr>
<td></td>
<td>Form, Content, and Extent of Audit Documentation</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Organization and Filing (Indexing)</td>
<td></td>
</tr>
<tr>
<td>AAM 7000</td>
<td>Correspondence, Confirmations &amp; Representations</td>
<td>7001</td>
</tr>
<tr>
<td></td>
<td>Control of Confirmations and Correspondence</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Requests for Confirmations and Related Materials</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Inquiries to Legal Counsel</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Management Representations and Representation Letters</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Communication With Those Charged With Governance</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Reliance Letter</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Proposal Letter</td>
<td></td>
</tr>
<tr>
<td>AAM 8000</td>
<td>Alerts</td>
<td>8001</td>
</tr>
<tr>
<td></td>
<td>Comprehensive Audit Risk Alert—2008</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Current Economic Crisis: Accounting and Auditing Considerations—2009</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Compilation and Review Developments—2008</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Health Care Industry Developments—2008</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Insurance Industry Developments—2008</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Depository and Lending Institution Industry Developments—2008</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Employee Benefit Plans Industry Developments—2009</td>
<td></td>
</tr>
<tr>
<td></td>
<td>State and Local Governmental Developments—2009</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Common Interest Realty Associations Industry Developments—2008</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Real Estate and Construction Industry Developments—2008</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Investment Companies Industry Developments—2008</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Securities Industry Developments—2008</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Not-for-Profit Entities Industry Developments—2009</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Government Auditing Standards and Circular A-133 Developments—2008</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Independence and Ethics Developments—2008</td>
<td></td>
</tr>
<tr>
<td></td>
<td>SEC and PCAOB Developments—2008</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Understanding the New Auditing Standards Related to Risk Assessment</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115</td>
<td></td>
</tr>
<tr>
<td>AAM 9000</td>
<td>Accountants’ Reports</td>
<td>9001</td>
</tr>
<tr>
<td></td>
<td>Format of Accountants’ Reports</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Unqualified Opinions</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Adverse Opinions</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Disclaimers of Opinion</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Qualified Opinions</td>
<td></td>
</tr>
<tr>
<td>Section</td>
<td>AAM 9000 Accountants’ Reports—continued</td>
<td></td>
</tr>
<tr>
<td>---------</td>
<td>----------------------------------------</td>
<td></td>
</tr>
<tr>
<td>9245</td>
<td>Information Accompanying Audited Financial Statements</td>
<td></td>
</tr>
<tr>
<td>9250</td>
<td>Engagements to Report on Internal Control</td>
<td></td>
</tr>
<tr>
<td>9260</td>
<td>Special Reports</td>
<td></td>
</tr>
<tr>
<td>9270</td>
<td>Unaudited Financial Statements of a Public Entity</td>
<td></td>
</tr>
<tr>
<td>9280</td>
<td>Lack of Independence</td>
<td></td>
</tr>
<tr>
<td>9300</td>
<td>Review of Interim Financial Information</td>
<td></td>
</tr>
<tr>
<td>9400</td>
<td>Accountants’ Reports on Condensed Financial Statements and Selected Financial Data</td>
<td></td>
</tr>
<tr>
<td>9500</td>
<td>Reports on Personal Financial Statements</td>
<td></td>
</tr>
<tr>
<td>9600</td>
<td>Reports on Employee Benefit Plans</td>
<td></td>
</tr>
<tr>
<td>9650</td>
<td>Reports on Financial Statements of Brokers and Dealers in Securities</td>
<td></td>
</tr>
<tr>
<td>9700</td>
<td>Reports for Investment Companies</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Section</th>
<th>AAM 10,000 Quality Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>10,001</td>
<td>Quality Control—General</td>
</tr>
</tbody>
</table>

10,250  Statement on Quality Control Standards
10,280  Interpretation No. 101-14 of Rule 101, Independence
10,300  Sample Quality Control Forms

[The next page is 1.]
Updated as of June 1, 2009, this edition has been substantially revised to

- include 2008 and select 2009 alerts (AAM section 8000).

**Scope of Audit and Accounting Manual**

This publication brings together for continuing reference a set of nonauthoritative audit tools and illustrations prepared by the AICPA staff.

**Arrangement of Material in Audit and Accounting Manual**

The contents of this volume are arranged as follows:

- Introduction
- Compilation and Review
- Engagement Planning and Administration
- Internal Control
- Designing and Performing Further Audit Procedures
- Audit Documentation
- Correspondence, Confirmations, and Representations
- Alerts
- Accountants’ Reports
- Quality Control

[The next page is 1001.]
Introduction

This manual has not been approved, disapproved, or otherwise acted upon by any senior technical committees of the American Institute of Certified Public Accountants or the Financial Accounting Standards Board and has no official or authoritative status.

TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>1100</td>
<td>Introduction</td>
<td>.01-.08</td>
</tr>
<tr>
<td>1200</td>
<td>How to Use the Audit and Accounting Manual</td>
<td>.01-.10</td>
</tr>
<tr>
<td></td>
<td>Overview</td>
<td>.01</td>
</tr>
<tr>
<td></td>
<td>Audits</td>
<td>.02-.06</td>
</tr>
<tr>
<td></td>
<td>Compilation and Review Services</td>
<td>.07-.09</td>
</tr>
<tr>
<td></td>
<td>Alerts</td>
<td>.10</td>
</tr>
</tbody>
</table>

[The next page is 1101.]
AAM Section 1100

Introduction

.01 This manual has been prepared by the staff of the AICPA and issued as a nonauthoritative practice aid. The materials included in it are intended primarily as a reference source for conducting audit, review, and compilation engagements. The objective is to provide practitioners with the tools needed to help plan, perform, and report on their engagements. The manual is not intended to serve as a complete or comprehensive quality control system. The manual, where practicable, offers choices and alternatives rather than particular positions. The use of this or any other practice aid requires the exercise of individual professional judgment. The manual is not a substitute for the authoritative technical literature, and users are urged to refer directly to applicable authoritative pronouncements for the text of technical standards.

.02 This manual is intended to be used in connection with engagements of nonpublic entities and is not intended to be used in connection with audits of public entities that are required to be audited under standards set by the Public Company Accounting Oversight Board.

.03 Some sections of the manual include quotations from Statements on Auditing Standards and other authoritative pronouncements. Those quotations are intended only to illustrate certain matters, not to serve as a substitute for careful study of the relevant pronouncements. Users of this practice aid are urged to refer directly to applicable authoritative pronouncements when appropriate. References are made throughout the manual to the original authoritative pronouncements and to their section numbers in AICPA Professional Standards to help users locate those authoritative pronouncements.

.04 The authors hope that the manual will be helpful to practitioners in the conduct of their audit and accounting practice. However, no generalized material, such as that included in this manual, can be a substitute for development and implementation by a firm of a system of quality control, which is appropriately comprehensive and suitably designed in relation to the firm’s organizational structure, its policies, and the nature of its practice.

.05 Explanation of References

AR = Reference to section number in AICPA Professional Standards (vol. 2) for Statements on Standards for Accounting and Review Services
AT = Reference to section number in AICPA Professional Standards (vol. 1) for Statements on Standards for Attestation Engagements
AU = Reference to section number in AICPA Professional Standards (vol. 1) for Statements on Auditing Standards
AUD = Reference to section number in the Auditing and Attestation Statements of Position in AICPA Technical Practice Aids
ET = Reference to section number in AICPA Professional Standards (vol. 2) for the Code of Professional Conduct, Interpretations of Rules of Conduct, and Ethics Rulings
FASB ASC = Reference to the Financial Accounting Standards Board Accounting Standards Codification™
GAAP = Generally accepted accounting principles in the United States

(continued)
This edition of the manual has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the last edition of the manual. Relevant guidance contained in official pronouncements issued through June 1, 2009, has been considered in the development of this edition of the manual. This includes relevant guidance issued up to and including the following:

- Revised interpretations issued through June 1, 2009, including Interpretation No. 1, “Use of Electronic Confirmations,” of AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 9330 par. .01–.08)
- SSARS No. 18, *Applicability of Statements on Standards for Accounting and Review Services* (AICPA, *Professional Standards*, vol. 2)

Users of this manual should consider guidance issued subsequent to those items in the preceding list to determine its effect on entities covered by this manual. In determining the applicability of a pronouncement, its effective date should also be considered.

**FASB Accounting Standards Codification™**

The accounting guidance in this manual, where such guidance exists, has been conformed to reflect reference to FASB ASC as it existed on June 1, 2009 (through FASB ASC Update 2009-179). Although FASB ASC is not effective at this date, FASB is expected to release it as authoritative July 1, 2009; therefore, this manual has been conformed to FASB ASC to assist you during this transition.

The manual is expected to be updated periodically. Changes will likely arise from three main sources:

1. Comments and suggestions from practitioners. Because this manual is a product of AICPA staff and not of a committee of practitioners, it is particularly important that practitioners advise the staff on any suggestions for material that could be improved or added.
2. Issuance of new official pronouncements.
3. Other additions to or deletions from the manual as a result of continued staff study.
AICPA STAFF
Dennis W. Ridge, Jr., CPA
Technical Manager,
Accounting and Auditing Publications

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Call Toll Free
(877) 242-7212
This service is free to AICPA members.

[The next page is 1201.]
AAM Section 1200

How to Use the Audit and Accounting Manual

Overview

.01 The Audit and Accounting Manual (AAM) is designed to provide practitioners with the tools needed to help plan, perform, and report on audit, review, and compilation engagements. The AAM is not intended to serve as a complete or comprehensive quality control system, and it is not intended to be used in connection with the audits of entities that are required to be audited under standards set by the Public Company Accounting Oversight Board. The AAM comprises the following sections.

<table>
<thead>
<tr>
<th>Section No.</th>
<th>Section Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>1000</td>
<td>Introduction</td>
</tr>
<tr>
<td>2000</td>
<td>Compilation and Review</td>
</tr>
<tr>
<td>3000</td>
<td>Engagement Planning and Administration</td>
</tr>
<tr>
<td>4000</td>
<td>Internal Control</td>
</tr>
<tr>
<td>5000</td>
<td>Designing and Performing Further Audit Procedures</td>
</tr>
<tr>
<td>6000</td>
<td>Audit Documentation</td>
</tr>
<tr>
<td>7000</td>
<td>Correspondence, Confirmations, and Representations</td>
</tr>
<tr>
<td>8000</td>
<td>Alerts</td>
</tr>
<tr>
<td>9000</td>
<td>Accountants’ Reports</td>
</tr>
<tr>
<td>10,000</td>
<td>Quality Control</td>
</tr>
</tbody>
</table>

Audits

.02 To perform an engagement in accordance with generally accepted auditing standards (GAAS), an auditor must comply with the General Standards, the Standards of Field Work, the Standards of Reporting, and the Quality Control Standards.

.03 The general standards are concerned with the qualifications of the auditor and the qualitative aspect of the work performed. They specifically address the auditor’s training and proficiency, independence, and due care in the performance of work.

.04 The Standards of Field Work address the manner used by the auditor to perform the audit. Each standard begins with the appointment of the auditor and ends with the auditor communicating to those responsible for the oversight of financial reporting of the entity being audited.

.05 The Standards of Reporting are concerned with the opinion the auditor renders on the client’s financial statements.

.06 The AAM will assist the auditor in performing an audit, in accordance with GAAS, in the following ways:

a. AAM section 10,000, Quality Control, includes sample forms that can be used by a firm to document its adherence to the AICPA requirement for a system of quality control for a CPA firm.
b. AAM section 3000, *Engagement Planning and Administration*, provides guidance in the planning stage. Included in this section are various formats of audit assignment controls and engagement letters.


d. AAM section 5000, *Designing and Performing Further Audit Procedures*, explains how the auditor should design and perform tests of controls, substantive procedures, or both, that are responsive to the assessed risks of material misstatement.

e. AAM section 6000, *Audit Documentation*, provides the auditor with a general discussion of the purpose of audit documentation.

f. AAM section 7000, *Correspondence, Confirmations, and Representations*, provides the auditor with numerous examples of confirmations, illustrative inquiries to legal counsel, representation letters, communications with audit committees, and a reliance letter.

g. AAM section 9000, *Accountants’ Reports*, addresses the format of the accountants’ report and provides numerous examples of the auditor’s report.

### Compilation and Review Services

.07 To perform either a review or a compilation engagement in accordance with Statements on Standards for Accounting and Review Services (SSARSs), an accountant must comply with the standards promulgated by the Accounting and Review Services Committee. As of the date of this manual, there have been 18 SSARSs issued. Refer to paragraph .10 of AAM section 2100, *Introduction*, for a complete list of the SSARSs that have been codified in the AICPA’s *Professional Standards*.

.08 The AAM will assist the accountant in performing compilation and review engagements in accordance with SSARS in the following ways:

a. AAM section 2200, *Engagement Planning and Administration*, provides guidance in the planning stage. Addressed are engagement letters, changes in the level of service for the engagement, sample acceptance form, sample information form, and sample engagement letters.

b. AAM section 2300, *Compilation Engagements*, provides sample procedures for compilation engagements, representation letters, and checklists.

c. AAM section 2400, *Review Engagements*, provides sample procedures for review engagements, representation letters, and checklists.

d. AAM section 2500, *Form and Content of Financial Statements*, provides guidance on the statements, notes, supplementary information, and subsequent discovery of facts.

e. AAM section 2600, *Reporting*, provides guidance on the basic reporting fundamentals for compilation and review engagements.


g. AAM section 2700, *Special Areas*, addresses other comprehensive bases of accounting, prescribed forms, and specified elements.

.09 It is suggested that the accountant also review the following areas for additional guidance when performing compilation and review engagements:
• Correspondence, Confirmations, and Representations (AAM section 7000)
• Quality Control (AAM section 10,000)

Alerts

.10 AAM section 8000, Alerts, is intended to provide accountants with an overview of recent economic, professional, and regulatory developments that may affect their engagements.

[The next page is 2001.]
AAM Section 2000
Compilation and Review

This section is a nonauthoritative other compilation and review publication as described in paragraph .07 of AR section 50. As such, the practice aid has no authoritative status; however, it may help an accountant understand and apply the Statements on Standards for Accounting and Review Services (SSARS).

If an accountant applies the guidance included in an other compilation and review publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the engagement and appropriate. This section has been reviewed by the AICPA Audit and Attest Standards staff and, therefore, is presumed to be appropriate. The exhibits are for illustrative purposes only. They are included as conveniences for users of this manual who may want points of reference when preparing working papers or a report for a compilation or review engagement.

### TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>2100</td>
<td>Introduction</td>
<td>.01-.27</td>
</tr>
<tr>
<td></td>
<td>Standards for Accounting and Review Services</td>
<td>.02-.05</td>
</tr>
<tr>
<td></td>
<td>Interpretative Publications</td>
<td>.06-.07</td>
</tr>
<tr>
<td></td>
<td>Other Compilation and Review Publications</td>
<td>.08-.09</td>
</tr>
<tr>
<td></td>
<td>Overview of SSARS and Interpretations</td>
<td>.10-.18</td>
</tr>
<tr>
<td></td>
<td>Accounting and Review Services Committee Proposed Revised Framework and Objectives for Performing and Reporting on Compilation and Review Engagements</td>
<td>.12-.18</td>
</tr>
<tr>
<td></td>
<td>Determining Applicability of AR Section 100</td>
<td>.19-.27</td>
</tr>
<tr>
<td>2200</td>
<td>Engagement Planning and Administration</td>
<td>.01-.68</td>
</tr>
<tr>
<td></td>
<td>Client and Engagement Selection</td>
<td>.03-.19</td>
</tr>
<tr>
<td></td>
<td>Documentation</td>
<td>.09-.10</td>
</tr>
<tr>
<td></td>
<td>Client Needs</td>
<td>.11-.13</td>
</tr>
<tr>
<td></td>
<td>Compilation Considerations</td>
<td>.14-.19</td>
</tr>
<tr>
<td></td>
<td>Independence Issues</td>
<td>.20-.26</td>
</tr>
<tr>
<td></td>
<td>Understanding the Engagement</td>
<td>.27</td>
</tr>
<tr>
<td></td>
<td>Establishing an Understanding With the Client</td>
<td>.28-.39</td>
</tr>
<tr>
<td></td>
<td>What to Include in an Engagement Letter</td>
<td>.32</td>
</tr>
<tr>
<td></td>
<td>Overcoming Client Resistance to an Engagement Letter</td>
<td>.33-.35</td>
</tr>
<tr>
<td></td>
<td>Engagement Letters for Monthly, Quarterly, or Comparative Statements</td>
<td>.36</td>
</tr>
<tr>
<td></td>
<td>Minimizing Liability to Third Parties</td>
<td>.37-.39</td>
</tr>
<tr>
<td></td>
<td>Change in Engagement Level of Service</td>
<td>.40-.46</td>
</tr>
<tr>
<td></td>
<td>Step-Ups</td>
<td>.41-.42</td>
</tr>
<tr>
<td></td>
<td>Step-Downs and Changes in Service</td>
<td>.43-.46</td>
</tr>
<tr>
<td></td>
<td>Communications Between Predecessor and Successor Accountants</td>
<td>.47-.53</td>
</tr>
<tr>
<td></td>
<td>Inquiries Regarding Acceptance of the Engagement</td>
<td>.50-.52</td>
</tr>
</tbody>
</table>
## Table of Contents

### Section 2200
- Engagement Planning and Administration—continued
  - Materially Misleading Financial Statements ........................................... .53
  - Subsequent Discovery of Facts ............................................................... .54-.59
  - Management-Use-Only Financial Statements Distributed to Third Parties ...... .60-.63
  - When to Consider Withdrawing From an Engagement .................................. .64-.68

### Section 2300
- Compilation Engagements ............................................................................... .01-.19
  - Type of Compilation ................................................................................... .01-.03
  - Performance Requirements for a Compilation Engagement ......................... .04-.15
    - Limitations of a Compilation Engagement .............................................. .06
    - Performance Requirements ....................................................................... .07
    - Reporting Requirements ........................................................................... .08-.09
    - Third Parties ......................................................................................... .10-.15
  - Documentation Requirement ........................................................................ .16-.17
  - Compilation of Financial Statements Flowchart ...................................... .18-.19

### Section 2400
- Review Engagements ..................................................................................... .01-.48
  - Overview ..................................................................................................... .01-.02
  - Knowledge of Accounting Principles and Practices of the Industry .............. .03-.07
  - Inquiries and Analytical Procedures ........................................................... .08
  - Analytical Procedures ................................................................................ .09-.14
  - Inquiries and Other Review Procedures ..................................................... .15-.23
    - Analytical Procedures in Initial Review Engagements ............................... .19-.21
    - When the Results of Analytical Procedures Are Not In Accordance With the Accountant’s Expectations ......................................................... .22-.23
  - Awareness Concerning Information Supplied .............................................. .24-.26
  - Representation Letters ................................................................................. .27-.32
  - Documentation ............................................................................................ .33-.36
  - Additional Guidance ................................................................................... .37-.39
  - Analytical Procedures the Accountant May Consider Performing When Conducting a Review of Financial Statements ........................................ .40-.48

### Section 2500
- Form and Content of Financial Statements ................................................ .01-.28
  - Title Page .................................................................................................... .02-.05
    - Name of the Entity .................................................................................... .03
    - Title of Financial Statements .................................................................... .04
    - Date or Period Covered ............................................................................ .05
  - Presentation of the Accountant’s Report ..................................................... .06-.12
    - Letterhead ................................................................................................ .07
    - Heading of the Accountant’s Report ......................................................... .08
    - Address ..................................................................................................... .09
    - Salutations ................................................................................................. .10
    - Signature ................................................................................................... .11
    - Date of Report ............................................................................................ .12
  - Basic Financial Statements ......................................................................... .13-.17
    - Heading .................................................................................................... .14
    - Reference on Financial Statements ........................................................... .15-.17
<table>
<thead>
<tr>
<th>Section</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>2500</td>
<td>2003</td>
</tr>
<tr>
<td>Form and Content of Financial Statements—continued</td>
<td>.18</td>
</tr>
<tr>
<td>Use of the Term <em>Unaudited</em></td>
<td>.18-23</td>
</tr>
<tr>
<td>Supplementary Information</td>
<td>.19-23</td>
</tr>
<tr>
<td>Presentation</td>
<td>.20</td>
</tr>
<tr>
<td>Reporting</td>
<td>.21</td>
</tr>
<tr>
<td>Headings</td>
<td>.22</td>
</tr>
<tr>
<td>Reference to Report</td>
<td>.23</td>
</tr>
<tr>
<td>Disclosures</td>
<td>.24-27</td>
</tr>
<tr>
<td>Referencing Notes</td>
<td>.28</td>
</tr>
<tr>
<td>2600</td>
<td>01-112</td>
</tr>
<tr>
<td>Reporting</td>
<td>.01-112</td>
</tr>
<tr>
<td>Reporting Obligation</td>
<td>.01-04</td>
</tr>
<tr>
<td>Basic Compilation Reports</td>
<td>.05-06</td>
</tr>
<tr>
<td>Basic Review Reports</td>
<td>.07-08</td>
</tr>
<tr>
<td>Reporting When Not Independent</td>
<td>.09-10</td>
</tr>
<tr>
<td>Reporting on Financial Statements That Omit Disclosures</td>
<td>.11-16</td>
</tr>
<tr>
<td>Reporting on Financial Statements With Departures From GAAP</td>
<td>.17-18</td>
</tr>
<tr>
<td>Reporting When There Are Significant Departures From GAAP</td>
<td>.19-20</td>
</tr>
<tr>
<td>Date of Reports</td>
<td>.21</td>
</tr>
<tr>
<td>Highest Level of Service</td>
<td>.22-27</td>
</tr>
<tr>
<td>Performing a Lower Level of Service</td>
<td>.28-29</td>
</tr>
<tr>
<td>Reporting When the Statement of Cash Flows or Comprehensive Income Information Is Omitted, or Both</td>
<td>.30-35</td>
</tr>
<tr>
<td>Reporting When Supplementary Information Is Included</td>
<td>.36-60</td>
</tr>
<tr>
<td>Client Prepared Supplementary Information</td>
<td>.44</td>
</tr>
<tr>
<td>Client Prepared Supplementary Information Bound in the Accountant’s Report Cover</td>
<td>.45</td>
</tr>
<tr>
<td>Supplementary Information Attached by the Client</td>
<td>.46-47</td>
</tr>
<tr>
<td>Forecast or Projection Included With Historical Financial Statements</td>
<td>.48-49</td>
</tr>
<tr>
<td>Pro Forma Information</td>
<td>.50-58</td>
</tr>
<tr>
<td>Reporting on Charts and Graphs</td>
<td>.59-60</td>
</tr>
<tr>
<td>Emphasis Paragraphs</td>
<td>.61-62</td>
</tr>
<tr>
<td>Going Concern Issues</td>
<td>.63-67</td>
</tr>
<tr>
<td>Full Disclosure Financial Statements</td>
<td>.63-64</td>
</tr>
<tr>
<td>Omission of Substantially All Disclosures</td>
<td>.65-67</td>
</tr>
<tr>
<td>Subsequent Events</td>
<td>.68-72</td>
</tr>
<tr>
<td>Full Disclosure Financial Statements</td>
<td>.68-69</td>
</tr>
<tr>
<td>Omission of Substantially All Disclosures</td>
<td>.70-72</td>
</tr>
<tr>
<td>Reporting When There Is a Scope Limitation</td>
<td>.73-78</td>
</tr>
<tr>
<td>Reporting on Financial Statements Included in Management Consulting Services Reports</td>
<td>.79-84</td>
</tr>
<tr>
<td>General</td>
<td>.79-80</td>
</tr>
<tr>
<td>Financial Statements Compiled or Reviewed by Another Accountant</td>
<td>.81-83</td>
</tr>
<tr>
<td>Client Prepared Financial Statements</td>
<td>.84</td>
</tr>
<tr>
<td>Section</td>
<td>Paragraph</td>
</tr>
<tr>
<td>---------</td>
<td>-----------</td>
</tr>
<tr>
<td>2600</td>
<td>Reporting—continued</td>
</tr>
<tr>
<td></td>
<td>Reporting When Only One Financial Statement Is Presented</td>
</tr>
<tr>
<td></td>
<td>Reporting on Comparative Financial Statements</td>
</tr>
<tr>
<td></td>
<td>General</td>
</tr>
<tr>
<td></td>
<td>Continuing Accountant’s Standard Report</td>
</tr>
<tr>
<td></td>
<td>Continuing Accountant’s Changed Reference to GAAP</td>
</tr>
<tr>
<td></td>
<td>Predecessor’s Compilation or Review Report</td>
</tr>
<tr>
<td></td>
<td>Restated Prior Period Financial Statements</td>
</tr>
<tr>
<td></td>
<td>Reporting When Prior Period Is Audited</td>
</tr>
<tr>
<td></td>
<td>Reporting on Financial Statements That Previously Did Not Omit Substantially All Disclosures</td>
</tr>
<tr>
<td></td>
<td>Change of Accountants—Reporting Following a Merger or Purchase of a Firm</td>
</tr>
<tr>
<td></td>
<td>Change of Accountants—Predecessor Accountant Has Ceased Operations</td>
</tr>
<tr>
<td></td>
<td>AR Section 200 Summary</td>
</tr>
<tr>
<td></td>
<td>Reporting When Other Accountants Have Audited or Reviewed a Component Preliminary Financial Statement Drafts</td>
</tr>
<tr>
<td>2610</td>
<td>Accountants’ Reports on Compilation of Financial Statements of a Nonissuer</td>
</tr>
<tr>
<td>2620</td>
<td>Accountants’ Reports on Review of Financial Statements of a Nonissuer</td>
</tr>
<tr>
<td>2700</td>
<td>Special Areas</td>
</tr>
<tr>
<td></td>
<td>Other Comprehensive Bases of Accounting</td>
</tr>
<tr>
<td></td>
<td>Deciding When to Use an OCBOA</td>
</tr>
<tr>
<td></td>
<td>Basic Financial Statements</td>
</tr>
<tr>
<td></td>
<td>Statement Titles</td>
</tr>
<tr>
<td></td>
<td>Disclosures</td>
</tr>
<tr>
<td></td>
<td>Cash Basis of Accounting</td>
</tr>
<tr>
<td></td>
<td>Income Tax Basis of Accounting</td>
</tr>
<tr>
<td></td>
<td>Nontaxed Entities</td>
</tr>
<tr>
<td></td>
<td>Other Bases of Accounting</td>
</tr>
<tr>
<td></td>
<td>Disclosure of Basis of Accounting</td>
</tr>
<tr>
<td></td>
<td>Other Disclosures</td>
</tr>
<tr>
<td></td>
<td>Reporting</td>
</tr>
<tr>
<td></td>
<td>Prescribed Forms</td>
</tr>
<tr>
<td></td>
<td>Background</td>
</tr>
<tr>
<td></td>
<td>Provisions of AR Section 300</td>
</tr>
<tr>
<td></td>
<td>Departures From GAAP or From the Prescribed Form</td>
</tr>
<tr>
<td></td>
<td>Signing a Preprinted Report Form</td>
</tr>
<tr>
<td></td>
<td>Determining When AR Section 300 Is Applicable</td>
</tr>
<tr>
<td></td>
<td>Personal Financial Statements</td>
</tr>
<tr>
<td></td>
<td>Personal Financial Statements Engagements</td>
</tr>
<tr>
<td></td>
<td>Acceptance of Clients</td>
</tr>
<tr>
<td></td>
<td>Engagement Letters</td>
</tr>
<tr>
<td>Section</td>
<td>Paragraph</td>
</tr>
<tr>
<td>--------------</td>
<td>-----------</td>
</tr>
<tr>
<td>2700 Special Areas—continued</td>
<td>2700</td>
</tr>
<tr>
<td>Client Representation Letters</td>
<td>2700.45</td>
</tr>
<tr>
<td>Compilation of Personal Financial Statements</td>
<td>2700.46-53</td>
</tr>
<tr>
<td>Review of Personal Financial Statements</td>
<td>2700.54-56</td>
</tr>
<tr>
<td>Reporting</td>
<td>2700.57-59</td>
</tr>
<tr>
<td>Exception for Personal Financial Statements Included in Written Financial Plans</td>
<td>2700.60-62</td>
</tr>
<tr>
<td>The Accountant’s Report</td>
<td>2700.63-64</td>
</tr>
<tr>
<td>Specified Elements, Accounts, or Items of a Financial Statement</td>
<td>2700.65-72</td>
</tr>
<tr>
<td>Relationship of Statements on Standards for Accounting and Review Services to Quality Control Standards</td>
<td>2700.73-75</td>
</tr>
</tbody>
</table>

2710 Accountants’ Reports on Prescribed Forms, Specified Elements, Personal Financial Statements, and OCBOA Financial Statements 2710.01-10

[The next page is 2101.]
AAM Section 2100

Introduction*

.01 Statements on Standards for Accounting and Review Services (SSARSs) are issued by the AICPA Accounting and Review Services Committee (ARSC), the senior technical committee of the AICPA designated by its Council to issue pronouncements in connection with unaudited financial statements and other unaudited financial information of nonissuers. (A complete listing of SSARSs and the full text can be found in AICPA Professional Standards, vol. 2.) A nonissuer is defined as all entities except for those defined as issuers. An issuer is defined in Section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), the securities of which are registered under Section 12 of that act (15 U.S.C. 78l), or that is required to file reports under Section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn. Thus, if an entity does not meet any of the definitions in Section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), it is a nonissuer.

Standards for Accounting and Review Services

.02 In accordance with paragraph .01 of AR section 50, Standards for Accounting and Review Services (AICPA, Professional Standards, vol. 2), an accountant must perform a compilation or review of a nonissuer in accordance with SSARSs issued by the AICPA. SSARSs provide a measure of quality and the objectives to be achieved in both a compilation and review.

.03 The SSARSs are issued by ARSC and provide performance and reporting standards for compilations and reviews.

.04 Rule 202, Compliance With Standards, (AICPA, Professional Standards, vol. 2, ET sec. 202 par. .01), of the AICPA Code of Professional Conduct states that an AICPA member who performs compilations or reviews shall comply with standards promulgated by bodies designated by AICPA Council. Bodies designated by AICPA Council to promulgate technical standards are enumerated in appendix A to Rule 202 and include, among others, ARSC. The ARSC develops and issues standards in the form of SSARSs through a due process that includes deliberations in meetings open to the public, public exposure of proposed SSARSs, and a formal vote. The SSARSs are codified.

.05 The accountant should have sufficient knowledge of the SSARSs to identify those that are applicable to his or her engagement. The nature of the SSARSs requires an accountant to exercise professional judgment in applying them. The accountant should be prepared to justify departures from the SSARSs.

Interpretative Publications

.06 Interpretative publications consist of compilation and review interpretations of the SSARSs, appendixes to the SSARSs, compilation and review guidance included in AICPA Audit and Accounting Guides, and AICPA Statements of Position to the extent that those statements are applicable to compilation and review engagements. Interpretative publications are not standards for accounting and review services. Interpretative publications are recommendations on the application of the SSARSs in specific circumstances, including engagements for entities in specialized industries. An interpretative publication is issued after all ARSC

* In February 2009, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 18, Applicability of Statements on Standards for Accounting and Review Services (AICPA, Professional Standards, vol. 2), which amends paragraph .01 of AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2). SSARS No. 18 revises the applicability of the SSARSs so that SSARSs do not apply when the provisions of AU section 722, Interim Financial Information (AICPA, Professional Standards, vol. 1), apply. SSARS No. 18 is effective for compilations and reviews of financial statements for periods beginning after December 15, 2009, with early application permitted. This manual will be updated for SSARS No. 18 in the next edition.
members have been provided an opportunity to consider and comment on whether the proposed interpretative publication is consistent with the SSARSs.

.07 The accountant should be aware of and consider interpretative publications applicable to his or her compilation or review. If the accountant does not apply the guidance included in an applicable interpretative publication, the accountant should be prepared to explain how he or she complied with the SSARSs provisions addressed by such guidance.

Other Compilation and Review Publications

.08 Other compilation and review publications include AICPA accounting and review publications not referred to above; AICPA’s annual Compilation and Review Alert; compilation and review articles in the Journal of Accountancy and other professional journals; compilation and review articles in AICPA’s The CPA Letter; continuing professional education programs and other instruction materials, textbooks, guide books, compilation and review programs, and checklists; and other compilation and review publications from state CPA societies, other organizations, and individuals. Other compilation and review publications have no authoritative status; however, they may help the accountant understand and apply the SSARSs.

.09 If an accountant applies the guidance included in an other compilation and review publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the engagement and appropriate. In determining whether an other compilation and review publication is appropriate, the accountant may wish to consider the degree to which the publication is recognized as being helpful in understanding and applying the SSARSs and the degree to which the issuer or author is recognized as an authority in compilation and review matters. Other compilation and review publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are presumed to be appropriate.

Overview of SSARSs and Interpretations

.10 ARSC has issued 18 SSARSs, which have been codified in the AICPA’s Professional Standards literature. They are as follows.

<table>
<thead>
<tr>
<th>Title</th>
<th>Summary</th>
<th>Professional Standards Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>SSARS No. 1, Compilation and Review of Financial Statements (December 1978)</td>
<td>Provides guidance to CPAs concerning the standards and procedures applicable to engagements to compile or review financial statements.</td>
<td>AR section 100</td>
</tr>
<tr>
<td>SSARS No. 2, Reporting on Comparative Financial Statements (October 1979)</td>
<td>Establishes standards for reporting on comparative financial statements of a nonissuer when financial statements of one or more periods have been compiled or reviewed in accordance with AR section 100.</td>
<td>AR section 200</td>
</tr>
</tbody>
</table>

1 The accountant is not expected to be aware of the full body of other compilation and review publications.
<table>
<thead>
<tr>
<th>Title</th>
<th>Summary</th>
<th>Professional Standards Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>SSARS No. 3, Compilation Reports on Financial Statements Included in Certain Prescribed Forms (December 1981)</td>
<td>Provides an alternative form of standard compilation report when a prescribed form or related instructions call for a specific departure from generally accepted accounting principles (GAAP). Also provides additional guidance applicable to reports on financial statements included in prescribed form.</td>
<td>AR section 300</td>
</tr>
<tr>
<td>SSARS No. 4, Communication Between Predecessor and Successor Accountants (December 1981)</td>
<td>Provides guidance to a successor accountant who decides to communicate with a predecessor accountant.</td>
<td>AR section 400</td>
</tr>
<tr>
<td>SSARS No. 5, Reporting on Compiled Financial Statements (July 1982; Deleted November 1992 by the issuance of SSARS No. 7)</td>
<td>Deleted by SSARS No. 7, November 1992 because the provisions of SSARS No. 5 have been incorporated into AR sections 100, 200, and 300.</td>
<td>AR section 500</td>
</tr>
<tr>
<td>SSARS No. 6, Reporting on Personal Financial Statements Included in Written Personal Financial Plans (September 1986)</td>
<td>Provides an exemption from AR section 100 for personal financial statements that are included in written personal financial plans prepared by an accountant and specifies the form of written report required under the exemption.</td>
<td>AR section 600</td>
</tr>
<tr>
<td>SSARS No. 7, Omnibus Statement on Standards for Accounting and Review Services—1992 (November 1992)</td>
<td>Contains a number of technical amendments to various standards. Integrated to amend AR sections 100, 200, 300, and 400 and deleted SSARS No. 5.</td>
<td>Not published as a stand-alone section.</td>
</tr>
<tr>
<td>SSARS No. 8, Amendment to Statement on Standards for Accounting and Review Services No. 1, Compilation and Review of Financial Statements (October 2000)</td>
<td>Amends AR section 100 to create a management-use-only compilation (and make other changes).</td>
<td>Not published as a stand-alone section.</td>
</tr>
<tr>
<td>SSARS No. 9, Omnibus Statement on Standards for Accounting and Review Services—2002 (November 2002)</td>
<td>Contains a number of technical amendments to AR sections 100 and 400.</td>
<td>Not published as a stand-alone section.</td>
</tr>
<tr>
<td>SSARS No. 11, Standards for Accounting and Review Services (May 2004)</td>
<td>Establishes a SSARS hierarchy and makes practitioners aware of the appropriate literature and the standing of various publications in the SSARS hierarchy. Also amended AR section 200.</td>
<td>AR section 50</td>
</tr>
<tr>
<td>SSARS No. 12, Omnibus Statement on Standards for Accounting and Review Services—2005 (July 2005)</td>
<td>Contains a number of technical amendments and additions to AR sections 100 and 200.</td>
<td>Not published as a stand-alone section.</td>
</tr>
</tbody>
</table>

(continued)
<table>
<thead>
<tr>
<th>Title</th>
<th>Summary</th>
<th>Professional Standards Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>SSARS No. 13, Compilation of Specified Elements, Accounts, or Items of a Financial Statement (July 2005)</td>
<td>Expands SSARSs to apply when an accountant is engaged to compile or issues a compilation report on one or more specified elements, accounts, or items of a financial statement.</td>
<td>AR section 110</td>
</tr>
<tr>
<td>SSARS No. 14, Compilation of Pro Forma Financial Information (July 2005)</td>
<td>Expands SSARSs to apply when an accountant is engaged to compile or issue a compilation report on pro forma financial information.</td>
<td>AR section 120</td>
</tr>
<tr>
<td>SSARS No. 15, Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services (July 2007)</td>
<td>Contains a number of technical amendments to AR sections 100, 200, 300, and 400.</td>
<td>Not published as a stand-alone section.</td>
</tr>
<tr>
<td>SSARS No. 16, Defining Professional Requirements in Statements on Standards for Accounting and Review Services (December 2007)</td>
<td>Defines the terminology the ARSC will use to describe the degrees of responsibility that the requirements impose on the accountant.</td>
<td>AR section 20</td>
</tr>
<tr>
<td>SSARS No. 17, Omnibus Statement on Standards for Accounting and Review Services—2008 (February 2008)</td>
<td>Contains a number of technical amendments to AR sections 100, 200, 300, and 400.</td>
<td>Not published as a stand-alone section.</td>
</tr>
<tr>
<td>SSARS No. 18, Applicability of Statements on Standards for Accounting and Review Services (February 2009)†</td>
<td>Revises the applicability of the SSARS so that SSARS do not apply when the provisions of AU section 722, <em>Interim Financial Information</em> (AICPA, Professional Standards, vol. 2), apply.</td>
<td>Not published as a stand-alone section.</td>
</tr>
</tbody>
</table>

In addition to SSARS Nos. 1–18, interpretations are issued by the ARSC to provide timely guidance on applying SSARSs. An interpretation is not as authoritative as a SSARS, but accountants may have to justify departure from an interpretation’s guidance if the quality of their work is questioned. Interpretations of the SSARSs can be found in AR sections 9100, 9200, 9300, 9400, and 9600 of AICPA Professional Standards, volume 2.

**Accounting and Review Services Committee Proposed Revised Framework and Objectives for Performing and Reporting on Compilation and Review Engagements**

The ARSC issued an exposure draft that would revise the standards for compilation and review engagements. The changes would affect the interplay between the standards and independence rules, permitting an accountant to issue a review report on financial statements when the accountant’s independence is impaired by performing nonattest services that were designed to improve the reliability of the client’s financial information.

† SSARS No. 18 is effective for compilations and reviews of financial statements for periods beginning after December 15, 2009, with early application permitted. Due to the effective date, SSARS No. 18 has not been incorporated into the text of this edition.
The draft includes a trio of proposed standards: Framework and Objectives for Performing and Reporting on Compilation and Review Engagements, Compilation of Financial Statements, and Review of Financial Statements. In drafting the proposed standards, the ARSC considered recommendations from the Private Company Practice Section (PCPS) Reliability Task Force. ARSC and PCPS believe the proposed standards will respond to many concerns of smaller business owners, users of small business financial statements, and CPAs who serve smaller entities.

The PCPS task force recommended ARSC consider revising its standards for situations in which an accountant’s independence is impaired in connection with the performance of a nonattest service relating to the design or operation of an aspect of internal control over financial reporting. These nonattest services help management prepare higher quality or more reliable financial statements.

The proposed standards would also harmonize the AICPA’s review standard with the International Auditing and Assurance Standards Board’s International Standard on Review Engagements No. 2400, Engagements to Review Financial Statements.

Significant proposed changes to the SSARSs include the following:

- The introduction of new terms such as moderate assurance, review evidence, and review risk to the review literature to harmonize with international review standards.
- A discussion of materiality in the context of a review engagement.
- A requirement that an accountant establish an understanding with management regarding the services to be performed through a written communication (that is, an engagement letter).
- The establishment of enhanced documentation requirements for compilation and review engagements.
- Guidance for practitioners who are engaged to perform a compilation or review engagement when they have also been engaged to perform nonattest services. The guidance includes reporting requirements for instances in which the accountant’s independence is impaired due to the performance of these services.
- The ability for an accountant to include a general description in the accountant’s compilation report regarding the reason(s) for an independence impairment.

The proposed effective date is for compilations and reviews of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

The proposed SSARSs are available for download at www.aicpa.org/download/auditstd/ED_Reliability_SSARS.pdf.

**Determining Applicability of AR section 100**

Paragraph .04 of AR section 100 defines a compilation of financial statements and a review of financial statements. A compilation of financial statements is defined as a service, the objective of which is to present, in the form of financial statements, information that is the representation of management (owners) without undertaking to express any assurance on the financial statements. A review of financial statements is defined as a service, the objective of which is to express limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with generally accepted accounting principles (GAAP).

Paragraph .04 of AR section 100 defines management as follows:

The person(s) responsible for achieving the objectives of the entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management is responsible for
the financial statements, including designing, implementing, and maintaining effective internal control over financial reporting.

.21 Paragraph .04 of AR section 100 defines those charged with governance as follows:

The person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. In some cases, those charged with governance are responsible for approving the entity’s financial statements (in other cases, management has this responsibility). In some entities, governance is a collective responsibility that may be carried out by a board of directors, a committee of the board of directors, a committee of management, partners, equivalent persons, or some combination thereof. Those charged with governance are specifically excluded from management, unless they perform management functions.

.22 Paragraph .04 of AR section 100 defines a financial statement as follows:

A presentation of financial data, including accompanying notes, derived from accounting records and intended to communicate an entity’s economic resources or obligations at a point in time, or the changes therein for a period of time, in accordance with generally accepted accounting principles (GAAP) or an OCBOA. Reference in the SSARSs to GAAP include, where applicable, an OCBOA. Financial forecasts, projections, and similar presentations, and financial presentations included in tax returns are not financial statements for purposes of this section. The following financial presentations are examples of financial statements and are not meant to be all-inclusive:

Appropriate GAAP financial statement titles:
- Balance sheet
- Statement of income
- Statement of comprehensive income
- Statement of retained earnings
- Statement of cash flows
- Statement of changes in owners’ equity
- Statement of assets and liabilities (with or without owners’ equity accounts)
- Statement on revenues and expenses
- Statement of financial position (condition)
- Statement of activities
- Summary of operations
- Statement of operations by product lines

Appropriate OCBOA financial statement titles:
- Balance sheet—cash basis
- Statement of assets and liabilities arising from cash transactions
- Statement of assets, liabilities, and stockholders’ equity—income tax basis
- Statement of revenue collected and expenses paid
- Statement of revenue and expenses—income tax basis
- Statement of income—statutory basis
- Statement of operations—income tax basis
.23 AR section 100 is applicable whenever an accountant submits unaudited financial statements of a nonissuer to a client or third parties. In accordance with paragraph .04 of AR section 100, submission of financial statements is defined as “presenting to a client or third parties financial statements that the accountant has prepared either manually or through the use of computer software.”

.24 Two actions are necessary in order to submit financial statements:

- Prepare financial statements, either manually or through the use of computer software, and
- Present the financial statements to a client or third party.

.25 Technical Questions and Answers (TIS) section 9150.25, “Determining Whether Financial Statements Have Been Prepared by the Accountant” (AICPA, Technical Practice Aids), provides additional guidance regarding what factors an accountant considers in determining whether he or she has prepared financial statements when his or her work effort results in or contributes to the existence of financial statements. Due to computer technology, it is often unclear whether existing financial statements have been “prepared” by an accountant or by management. Some factors that an accountant may consider include the following:

- The process used to create the financial statements. If an accountant takes a client’s trial balance and puts the accounts into a format that would represent a financial statement, then an accountant has probably prepared the financial statements. The less an accountant has to do with creating the statements, the less likely an accountant would be deemed to have prepared the statements.
- Whether the client engaged the accountant to prepare financial statements or reasonably expected that as part of the professional services engagement the accountant would prepare financial statements. An accountant may determine that he or she prepared financial statements even when not so engaged if, as part of an accounting or bookkeeping services engagement, in the accountant’s professional judgment, the client reasonably expected that the existing financial statements were prepared as a product of that engagement.
- The extent of work effort that an accountant contributed to the existence of the financial statements. For example, if an accountant is intricately involved in adjusting the general ledger and other accounts that are, in turn, presented in a financial statement format, the more likely an accountant may be viewed as preparing the financial statements. On the other hand, if an accountant is not very involved in the accounting process, the less likely that an accountant would be deemed to have prepared the financial statements.
- Where the underlying accounting information resides. If all the accounting data reside on the accountant’s computer, it is more likely that the accountant is deemed to have prepared the financial statements. However, based on the facts and circumstances of the situation, an accountant may conclude that he or she prepared financial statements through the use of accounting or bookkeeping software utilized by the client.

Considerations such as who printed the financial statements or the location at which an accountant’s services were performed (for example, at the client’s location or the accountant’s location) are generally not factors in determining whether the accountant has prepared financial statements.

.26 The term presenting is also not defined in SSARSs. Again, the accountant will have to use his or her professional judgment to determine if financial statements have been presented to a client. Obviously, physically presenting printed financial statements would meet the definition used here. Other situations, especially those involving electronic presentation (for example, via e-mail) may be carefully considered.

.27 The accountant may wish to address the issue of submission early in engagement planning.
AAM Section 2200

Engagement Planning and Administration

.01 It is important to remember that when engaged to provide compilation or review services, the accountant shall comply with Rules 201, General Standards, and 202, Compliance With Standards (AICPA, Professional Standards, vol. 2, ET sec. 201 par. .01 and ET sec. 202 par. .01, respectively), of the AICPA Code of Professional Conduct. Rule 201 states that an AICPA member shall comply with the following standards and any interpretations thereof by bodies designated by its Council:

- **Professional competence.** Undertake only those professional services that the member or the member’s firm can reasonably expect to be completed with professional competence.
- **Due professional care.** Exercise due professional care in the performance of professional services.
- **Planning and supervision.** Adequately plan and supervise the performance of professional services.
- **Sufficient relevant data.** Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

.02 Rule 202 states that an AICPA member who performs compilations or reviews shall comply with standards promulgated by bodies designated by the AICPA Council. Bodies designated by the AICPA Council to promulgate technical standards are enumerated in appendix A to Rule 202 and include, among others, Accounting and Review Services Committee (ARSC). The ARSC develops and issues standards in the form of Statements on Standards for Accounting and Review Services (SSARSs) through a due process that includes deliberations in meetings open to the public, public exposure of proposed SSARSs, and a formal vote. The SSARSs are codified.

Client and Engagement Selection

.03 Prior to accepting an engagement to perform a compilation or review for all prospective or existing clients, the accountant may consider if he or she wishes to be, or continue to be, associated with them. Factors such as the ability of the accountant to adequately serve the client, the fee arrangement, and client integrity may be considered.

.04 The firm’s client acceptance and continuance policies represent a key element in mitigating litigation and business risk. The integrity and reputation of a client’s management could reflect on the reliability of the client’s accounting records and financial representations and, therefore, on the firm’s reputation or involvement in litigation.

.05 The accountant may consider the following elements in determining whether or not to accept a client. Certain of these elements may not be applicable to every engagement. Those elements the accountant might consider include the following:

- Information that might bear on the integrity or competence of management. Is there information that gives reason to doubt the integrity or competence of management?
- Past experience with management. Have past experiences on other engagements been positive?

\* In February 2009, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 18, Applicability of Statements on Standards for Accounting and Review Services (AICPA, Professional Standards, vol. 2), which amends paragraph .01 of AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2). SSARS No. 18 revises the applicability of the SSARSs so that SSARSs do not apply when the provisions of AU section 722, Interim Financial Information (AICPA, Professional Standards, vol. 1), apply. SSARS No. 18 is effective for compilations and reviews of financial statements for periods beginning after December 15, 2009, with early application permitted. This manual will be updated for SSARS No. 18 in the next edition.
• Independence and objectivity considerations.
• Communication with predecessor accountants or auditors.
• Assessment of management’s commitment to the appropriate application of generally accepted accounting principles. Ask the prospective client about its significant accounting policies.
• Assessment of management’s commitment to implementing and maintaining effective internal control. Ask management about its commitment to implementing and maintaining effective internal control including antifraud programs and controls. Ask about the entity’s control environment, risk assessment process, information and communications systems relevant to financial reporting, and control and monitoring activities that are in place, and any changes that management believes can be made to enhance the effectiveness of the entity’s internal control.
• Assessment of the entity’s financial viability.
• Inquiry of third parties.
• Other considerations. The following listing of other considerations is not intended to be all inclusive, and the accountant may consider whether other conditions are present that may create significantly increased risk, and carefully assess those conditions that are identified:
  — Restrictions on scope of services
  — Entities under common control
  — One-time engagements
  — Business and industry environment

.06 As part of the client acceptance procedures, a firm should consider its ability to provide professional services, based on industry expertise, size of engagement, and personnel available to staff the engagement.

.07 Some of the following procedures may help when evaluating a potential client:
• Gain access to available financial information. Review the prior year’s financials, with emphasis on leverage for debt. Look at the client’s assets and sources of income, as well as the current condition of accounting records.
• Review S&P, Moody’s, or other publications. Many localities provide a local or regional S&P in conjunction with the Daily Journal of Commerce or similar business publication. There is a plethora of available information on the Web. In addition, many firms offer database searches of financial, legal, and operational information, as well as personal information about key executives. Check the court dockets (including the U.S. Bankruptcy and Tax Court dockets) in the area where the client is domiciled.
• Meet with financial persons of the company. Ask for a brief overview of their internal practices and procedures, the business plan, bylaws, staff turnover, and so on. Representatives from other departments may provide information as well.
• Discuss the prospective client with former accountants (after the client provides written authorization).

.08 It is often useful to complete a client acceptance and continuance form to assist in determining whether or not to accept a client. An illustrative client acceptance form can be found in paragraph .65.

Documentation

.09 Whether or not an engagement is accepted or a professional relationship continued, the firm may document its consideration of the elements of the acceptance and continuance process. If the prospective client becomes or is continued as an attest client of the firm, the firm should comply with its document retention policies regarding the client acceptance or continuance consideration. The documentation with respect to prospective clients not accepted need only be retained for purposes of review by the appropriate level of firm management.
When issues have been identified and the firm has decided to accept or continue the client relationship or a specific engagement, the firm should document how the issues were resolved.

### Client Needs

When helping the client decide what level of service is appropriate, the accountant may wish to give special consideration to the issues of independence and the requests of bankers and other creditors on the client.

Several issues for the client to consider in determining the best type of engagement include the following:

- **Needs of third parties.** Does a third party (for example, a bank) need financial statements on a regular basis?

- **Cost-benefit considerations.** Which engagement can be performed at a reasonable cost to the client?

If the client does not need audited financial statements, the client can choose from, among others, the following types of engagements:

- A review (if the accountant is independent)
- A compilation (the minimum level of service required if third parties will use the financial statements)
- Bookkeeping services (available if the procedures do not include the submission of financial statements)

### Compilation Considerations

Paragraph .04 of AR section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2), defines a **compilation** as follows:

A service, the objective of which is to present in the form of financial statements information that is the representation of management (owners) without undertaking to express any assurance on the financial statements.

An engagement to compile financial statements does not require the accountant to make inquiries or perform other procedures to verify, corroborate, or review information supplied by management but, simply, to place the information into the form of financial statements. However, the accountant may make inquiries or perform other procedures.

An accountant’s compilation report is required to accompany the compiled financial statements when the financial statements are expected to be used by a third party or the accountant is engaged to report on the financial statements. If the financial statements are not expected to be used by a third-party and the client has not engaged the accountant to report on the compiled financial statements, the accountant may elect to not report on the financial statements provided the accountant has obtained a written understanding of the engagement with the client.

The accountant must perform the engagement in accordance with AR section 100.

If the client does not need compiled financial statements, the client may, instead, choose to have the accountant perform only bookkeeping services. Other than the broad, general ethical guidance available in ET section 201 of the AICPA Code of Professional Conduct, there are no authoritative standards for bookkeeping services. Thus, it is advisable that the accountant establish a written understanding with the client concerning bookkeeping services. This understanding may include the following:

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1 See paragraph .15 for more information about types of compilations.

AICPA Audit and Accounting Manual
A description of the nature and limitations of the services

A statement that the engagement cannot be relied upon to detect errors, fraud, or illegal acts

A written engagement letter for a bookkeeping services engagement is important because there are no specific standards to follow for these types of engagements. Other professional engagements, such as audits, reviews, and compilations, include the added benefit of authoritative standards that define the engagement objectives, limitations, communication, and so on.

Independence Issues

If an accountant is not independent, he or she can perform a compilation service (with report modification). If the client needs reviewed or audited financial statements, the nonindependent CPA may refer the client to another CPA. The primary rules governing independence are found in the Independence, Integrity, and Objectivity section of the AICPA Code of Professional Conduct. The independence standards are contained in Rule 101, Independence (AICPA, Professional Standards, vol. 2, ET sec. 101 par. 01), along with the associated interpretations and ethics rulings. Rule 101 states that “a member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council.”

In the final analysis, independence in mental attitude means objective consideration of facts, unbiased judgments, and honest neutrality on the part of the CPA in forming and expressing conclusions. Independence in mental attitude presumes an undeviating concern for an unbiased conclusion.

The appearance of independence is stressed because the possession of intrinsic independence is a matter of personal quality rather than of rules that formulate certain objective tests.

Interpretation No. 101-3, “Performance of nonattest services,” of ET section 101, Independence (AICPA, Professional Standards, vol. 2, ET sec. 101 par. 05), states that a member who performs attest services should not perform management functions or make management decisions for an attest client. (However, the member may provide advice, research materials, and recommendations to assist the client’s management in performing its functions and making decisions.) If a member is engaged to perform nonattest services, the client must agree to perform the following functions in connection with the engagement:

- Make all management decisions and perform all management functions
- Designate an individual who possesses suitable skill, knowledge, or experience, or some combination, preferably within senior management, to oversee the services
- Evaluate the adequacy and results of the services performed
- Accept responsibility for the results of the services

The member should be satisfied that the client will be able to meet all these criteria and to make an informed judgment on the results of the member’s nonattest services. In assessing whether the designated individual possesses suitable skill, knowledge, or experience, or some combination, the member should be satisfied that the individual understands the services to be performed sufficiently to oversee them. However, the individual is not required to possess the expertise to perform or re-perform the services. In cases where the client is unable or unwilling to assume these responsibilities (for example, the client does not have an individual with suitable skill, knowledge, or experience, or some combination, to oversee the nonattest services provided, or is unwilling to perform such functions due to lack of time or desire), the member’s provision of nonattest services would impair independence. Before performing nonattest services, the member should establish and document in writing his or her understanding with the client (board of directors, audit committee, or management, as appropriate in the circumstances) regarding the following:

- Objectives of the engagement
- Services to be performed
• Client’s acceptance of its responsibilities
• Member’s responsibilities
• Any limitations of the engagement

Practice Tip
The documentation requirement does not apply to nonattest services performed prior to the client becoming and attest client.

.25 Interpretation No. 101-3 provides examples of nonattest services and whether performance of those services would impair independence.

.26 As with many rules and standards of the profession, the guidance for independence is continually evolving to meet the developments and pressures facing the profession. Nevertheless, CPAs and their firms should take steps to ensure they meet the independence requirements before performing any review engagement service for a client.

Understanding the Engagement

.27 Paragraph .05 of AR section 100 states that the accountant should establish an understanding with the entity, preferably in writing, regarding the services to be performed. If the engagement is to compile financial statements not expected to be used by a third party, a written communication is required. (See paragraphs .24–.25 of AR section 100.)

Practice Tip
Interpretation No. 31, “Preparation of Financial Statements for Use by an Entity’s Auditors,” of AR section 100 (AICPA, Professional Standards, vol. 2, AR sec. 9100 par. 136–137), indicates that in situations when a client engages an accountant other than its auditor to prepare unaudited financial statements on behalf of management and those financial statements are provided by management to its outside auditor for the purposes of the annual audit, the auditor, who is a third party, is not deemed to be a user of the unaudited financial statements.

Establishing an Understanding With the Client

.28 As noted in the previous paragraph, paragraph .05 of AR section 100 states the CPA should establish an understanding with the client. This understanding should include the following:

   a. A description of the nature and limitations of the services to be performed.
   b. A description of the report, if a report is to be issued.
   c. A statement that the engagement cannot be relied upon to detect errors, fraud, or illegal acts.
   d. A statement that the accountant will inform the appropriate level of management of any material errors and of any evidence or information that comes to the accountant’s attention during the performance of compilation or review procedures that fraud or an illegal act may have occurred.2 The accountant need not report any matters regarding illegal acts that may have occurred that are clearly

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2 Whether an act is, in fact, fraudulent or illegal is a determination that is normally beyond the accountant’s professional competence. An accountant, in reporting on financial statements, presents himself or herself as one who is proficient in accounting and compilation or review services. The accountant’s training, experience, and understanding of the client and its industry may provide a basis for recognition that some client acts coming to his or her attention may be fraudulent or illegal. However, the determination as to whether a particular act is fraudulent or illegal would generally be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law.

AICPA Audit and Accounting Manual

AAM §2200.28
inconsequential and may reach agreement in advance with the entity on the nature of any such matters to be communicated.

.29 If the financial statements are not expected to be used by third parties (management-use-only compilation), the documentation of understanding should include the following descriptions or statements, according to paragraph .25 of AR section 100:

- The nature and limitations of the services to be performed.
- A compilation is limited to presenting in the form of financial statements information that is the representation of management.
- The financial statements will not be audited or reviewed.
- No opinion or any other form of assurance on the financial statements will be provided.
- Management has knowledge about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements.
- Acknowledgement of management’s representation and agreement that the financial statements are not to be used by third parties.
- The engagement cannot be relied upon to disclose errors, fraud, or illegal acts.

.30 According to paragraph .25 of AR section 100, the documentation of understanding should also address the following additional matters, if applicable:

- Material departures from generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting (OCBOA) may exist, and the effects of those departures, if any, may not be disclosed.
- Substantially all disclosures (and statement of cash flows, if applicable) required by GAAP or OCBOA may be omitted.
- Lack of independence.
- Reference to any supplementary information.

.31 A written engagement letter, though not required in a traditional compilation engagement, provides a means of formalizing the understanding between the accountant and the client concerning the services to be rendered. Engagement letters are advantageous for the following reasons:

- They help to avoid client misunderstandings.
- They help to avoid staff misunderstandings.
- They reduce potential legal liability.
- They improve practice management.
- They clarify contractual obligations.

What to Include in an Engagement Letter

.32 The accountant may include the in the engagement letter the following items, which are suggestions only and do not represent authoritative requirements:

- Identification of the client
- Record retention policy
- Description of the services to be provided
- Responses to subpoenas and outside inquiries
- Staffing of the engagement
• Explanation of how fees and costs will be billed
• Description of client responsibilities
• Payment terms
• Designation of client contacts
• Consequences of nonpayment
• Timing of the work
• Alternative dispute resolution
• Consequences of extending completion deadlines
• Withdrawal and termination
• Requests for additional services
• Client signature
• Client communications required by the AICPA
• Provisions to resolve potential ethical conflicts
• Any matter or terms unique to an engagement that are agreed upon in advance of rendering services

Overcoming Client Resistance to an Engagement Letter

.33 If the accountant encounters a situation in which the client exhibits reluctance about or resentment to an engagement letter, presenting the engagement letter face-to-face usually is sufficient to overcome any resistance on the part of the client.

.34 As an alternative to having the client sign an engagement letter, the accountant may consider developing a letter of understanding and mailing it to the client as a confirmation of the oral understanding. If an engagement letter is not obtained, the accountant may prepare a memorandum for the working papers describing the understanding with the client.

.35 Management is not required to sign the engagement letter, but it is preferable and highly advisable. Obtaining management’s signature on the engagement letter helps to ensure that management has read and understands the letter and the engagement. If the engagement letter is mailed to the client, it may be advisable to send the letter by certified mail or another means that would provide proof of receipt. In any case, a copy of the engagement letter is typically included in the working papers.

Engagement Letters for Monthly, Quarterly, or Comparative Statements

.36 One engagement letter can be drafted to cover financial statements issued for a period of time, such as a year, or for comparative financial statements issued for multiple periods. It is also possible to use one engagement letter for all services to be performed (for example, compilation, review, consulting, bookkeeping, and tax services). However, the accountant should carefully evaluate addressing multiple levels of service (for example, compilation and review) in one engagement letter because this can confuse the client.

Minimizing Liability to Third Parties

.37 In certain cases, it may be beneficial to identify in the engagement letter any third parties that the accountant knows will use the compilation or review report to limit the ability of unknown third parties’ use of the financial statements. For example, if the accountant knows at the time of the engagement that the client is negotiating with a bank for a loan of $100,000, the following language might be added to the engagement letter:

We understand that you are negotiating with Last National Bank for a loan of $100,000 and that you will present the compiled [reviewed] financial statements and our report thereon to Last National Bank. We
are not aware of any other persons, entities, or limited groups of persons or entities for whose use our report is intended or contemplated.

.38 The use of language such as this in engagement letters varies in practice. Some accountants feel that the language may offend clients or actually increase the likelihood of litigation from the identified third party, or both. Before adding such language, the accountant may wish to consult with legal counsel.

.39 Illustrative engagement letters for compilation engagements are presented in paragraphs .66–.67.

Practice Tip
The accountant should carefully evaluate adding language about additional services to the engagement letter. Also, be careful when using a proposal or preliminary engagement letter for a client. If the letter describes additional services that are not finally agreed upon, it may be used in litigation as an indication of inadequate performance by the accountant on the engagement. The accountant also may ensure that a final engagement letter is always issued in such circumstances.

Change in Engagement Level of Service

.40 Occasionally, during the course of an engagement, the client may request that the accountant change the nature of the engagement. The request may be for a

- step-up—for example, from a compilation to a review.
- step-down—for example, from an audit to a review or compilation.
- step-down—for example, from a review to a compilation.
- change in subject-matter—for example, from a compilation of full disclosure financial statements to a compilation of financial statements that omit substantially all disclosures.
- change in service—for example, from a compilation to bookkeeping services.

Step-Ups

.41 AR section 100 does not specifically address step-ups. Generally, step-ups pose no issues of great concern. The accountant might

- determine what additional procedures and standards are required for the level of service requested.
- determine whether it is possible and practical to perform the procedures and comply with the standards.
- revise the understanding with the client.

.42 If the client prepares financial statements for third-party use, the accountant may compile, review, or audit the financial statements for that client and comply with the reporting requirements in AR section 100. The accountant may do this even if he or she has previously compiled the financial statements for management’s use only.

Practice Tip
The accountant may want to include language in the engagement letter alerting the client to the fact that if it prepares financial statements for third-party use, the accountant may compile, review, or audit the financial statements in a separate engagement.
Step-Downs and Changes in Service

Step-Down From Audit to Review or Compilation

.43 Paragraphs .86–.91 of AR section 100 discuss 3 reasons that might cause a client to request a change from an audit engagement to another type of engagement after an audit has begun. They are as follows:

A change in circumstances affecting the entity’s requirement for an audit

- For example, a bank may no longer require an audit because a line-of-credit is reduced to a level that does not require audited financial statements.
- Generally, a step-down, in this case, is acceptable.

A misunderstanding as to the nature of an audit, review, or compilation

- Generally, a step-down, in this case, is acceptable.
- The accountant may consider explaining all of the options available to the client.

A restriction on the scope of the audit, whether imposed by the client or caused by circumstances

- Carefully consider the implications of a scope restriction
- Paragraph .89 of AR section 100 describes the following 2 circumstances that would preclude a step-down:
  - The client has prohibited the accountant from corresponding with the entity’s legal counsel.
  - The client has refused to provide the accountant with a signed representation letter.

Step-Down From Review to Compilation

.44 Paragraph .86 of AR section 100 lists the following 3 reasons that might cause a client to request a change after a review has begun:

A change in circumstances affecting the entity’s requirement for a review

- For example, a bank may no longer require a review because a line-of-credit is reduced to a level that does not require reviewed financial statements.
- Generally, a step-down, in this case, is acceptable.

A misunderstanding as to the nature of a review or compilation

- Generally, a step-down, in this case, is acceptable.
- The accountant may consider explaining all of the options available to the client.

A restriction on the scope of the inquiries or analytical procedures, whether imposed by the client or caused by circumstances.

- Carefully consider the implications of a scope restriction.
- Client refusal to provide the accountant with a signed representation letter would preclude a step-down.

Change in Subject Matter From Full Disclosure Financial Statements to Financial Statements That Omit Substantially All Disclosures

.45 The accountant can agree to a request to change in subject matter from a compilation with full disclosure financial statements to a compilation with financial statements that omit substantially all disclosures only if, to the best of his or her knowledge, the omission of disclosures is not intended to mislead those who might reasonably be expected to use the statements.
Step-Down From a Compilation to a Bookkeeping Engagement

.46 The accountant can agree to a request to step-down from a management-use-only compilation to bookkeeping services if the accountant feels that the services will not constitute preparing and presenting financial statements to the client or third parties.

Communications Between Predecessor and Successor Accountants

.47 AR section 400, Communications Between Predecessor and Successor Accountants (AICPA, Professional Standards, vol. 2), establishes requirements and guidance regarding communication between predecessor and successor accountants. Unlike AU section 315, Communications Between Predecessor and Successor Auditors (AICPA, Professional Standards, vol. 1), which establishes requirements and guidance regarding communication between predecessor and successor auditors, AR section 400 does not establish requirements for a successor accountant to communicate with a predecessor accountant in connection with acceptance of a compilation or review engagement, but he or she may believe it is beneficial to obtain information that will assist in determining whether to accept the engagement. The successor accountant may consider making inquiries of the predecessor accountant when circumstances such as the following exist:

- Information obtained about the prospective client and its management and principals is limited or requires special attention.
- The change in accountants occurs substantially after the end of the accounting period for which financial statements are to be compiled or reviewed.
- The client has frequently changed accountants.

.48 The successor accountant should bear in mind that the predecessor accountant and the client may have disagreed about accounting principles, procedures applied by the predecessor accountant, or similarly significant matters.

.49 The successor accountant should request permission from the prospective client to make any inquiries of the predecessor accountant. Except as permitted by the AICPA Code of Professional Conduct, an accountant is precluded from disclosing any confidential information obtained in the course of an engagement unless the client specifically consents. Accordingly, if the successor accountant decides to communicate with the predecessor, the successor accountant should request the client to (a) permit the successor accountant to make inquiries of the predecessor accountant and (b) authorize the predecessor accountant to respond fully to those inquiries. If the prospective client refuses to permit the predecessor accountant to respond or limits the response, the successor accountant should inquire about the reasons and consider the implications of that refusal in connection with acceptance of the engagement (see paragraph .04 of AR section 400).

Inquiries Regarding Acceptance of the Engagement

.50 According to paragraph .05 of AR section 400, if a successor accountant decides to communicate with the predecessor accountant, either orally or in writing, the inquiries should be specific and reasonable regarding matters that will assist the successor accountant in determining whether to accept the engagement. Matters subject to inquiry may include the following:

- Information that might bear on the honesty or integrity of management (owners)
- Disagreements with management (owners) about accounting principles or the performance of certain compilation or review procedures or similarly significant matters
- Cooperation from management (owners) when additional or revised information is needed
- Predecessor’s knowledge of any fraud or illegal acts perpetrated within the client
- Predecessor’s understanding of the reason for the change of accountants
.51 Paragraph .06 of AR section 400 states that the predecessor accountant, when authorized by the client, should respond promptly and fully to the inquiries on the basis of known facts. If the predecessor accountant decides, due to unusual circumstances such as impending, threatened, or potential litigation; disciplinary proceedings; or other unusual circumstances, not to respond fully to the inquiries, the predecessor accountant should indicate that the response is limited. (Note: Unpaid fees are not considered to be an unusual circumstance for purposes of this paragraph; however, see the following paragraph that discusses paragraph .08 of AR section 400) The successor accountant should consider the reasons and consider the implications of such a response in connection with acceptance of the engagement.

.52 Paragraph .08 of AR section 400 states that the successor accountant may review the predecessor’s working papers. In these circumstances, the successor accountant should request the client to authorize the predecessor accountant to allow access. Ordinarily, the predecessor accountant should make available certain working papers relating to matters of continuing significance and those relating to contingencies. However, valid business reasons may lead the predecessor accountant to decide not to allow access to the working papers. Unpaid fees constitute a valid business reason to deny access to the predecessor accountant’s working papers. The predecessor accountant may decide to reach an understanding with the successor accountant about the use of the working papers. Before permitting access to the working papers, the predecessor accountant may obtain a written communication from the successor accountant regarding the use of the working papers. The appendix to AR section 400 contains an illustrative successor accountant acknowledge-ment letter that is presented for illustrative purposes only and not required by professional standards. In addition, a predecessor accountant is not obligated to make himself or herself or the working papers available to more than one prospective successor accountant.

Materially Misleading Financial Statements

.53 If during the engagement, the successor accountant becomes aware of information that causes him or her to believe that the financial statements reported on by the predecessor accountant may need to be revised, the successor accountant should request the client to communicate the matter to the predecessor accountant. If the client refuses to do so or if the predecessor accountant’s response is inadequate, the successor accountant should evaluate (a) possible implications for the current engagement and (b) whether to resign from the engagement. Furthermore, the successor accountant may decide to consult with legal counsel in determining an appropriate course of further action.

Subsequent Discovery of Facts

.54 After compiling or reviewing a client’s financial statements and issuing a report, the accountant may become aware of facts that lead him or her to believe that information supplied by the entity may have been incorrect, incomplete, or otherwise unsatisfactory had the accountant then been aware of such facts. Because of the variety of conditions that might be encountered, some of the procedures discussed subsequently are necessarily set out only in general terms; the specific actions to be taken in a particular case may vary with the circumstances. The accountant would be well advised to consult with his or her legal counsel and insurance provider when he or she encounters the circumstances to which this section may apply because of legal implications that may be involved in actions contemplated herein.

.55 As stated in paragraph .78 of AR section 100, after the date of the accountant’s compilation or review report, the accountant has no obligation to perform other compilation or review procedures with respect to the financial statements, unless new information comes to his or her attention. However, when the accountant becomes aware of information that relates to financial statements previously reported on by him or her, but that was not known to the accountant at the date of the report, and that is of such a nature and from such a source that the accountant would have investigated it had it come to his or her attention during the course of the compilation or review, the accountant should, as soon as practicable, undertake to determine whether the information is reliable and whether the facts existed at the date of the report. In this connection, the accountant should discuss the matter with his or her client at whatever management levels the accountant deems appropriate, including the board of directors, and request cooperation in whatever investigation may be necessary. If the nature and effect of the matter are such that (a) the accountant’s report or the financial
statements would have been affected if the information had been known to the accountant at the accountant’s compilation or review report date and had not been reflected in the financial statements and (b) the accountant believes that there are persons currently using or likely to use the financial statements who would attach importance to the information, the accountant should

- in a compilation engagement, obtain additional or revised information.
- in a review engagement, perform the additional procedures deemed necessary to achieve limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with GAAP.

With respect to (b), consideration should be given, among other things, to the time elapsed since the financial statements were issued.

.56 When the accountant has concluded, after considering (a) and (b) in the preceding paragraph as appropriate, that action should be taken to prevent further use of the accountant’s report or the financial statements, the accountant should advise his or her client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are known to be currently using or who are likely to use the financial statements. When the client undertakes to make appropriate disclosure, the method used and the disclosure made will depend on the circumstances.

a. If the effect on the accountant’s report or the financial statements of the subsequently discovered information can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and, where applicable, the accountant’s report. The reasons for the revision usually should be described in a note to the financial statements and, where applicable, referred to in the accountant’s report. Generally, only the most recently issued, compiled, or reviewed financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years.3

b. When issuance of financial statements for a subsequent period is imminent, so that disclosure is not delayed, appropriate disclosure of the revision can be made in such statements instead of reissuing the earlier statements pursuant to subparagraph (a).4

c. When the effect on the financial statements of the subsequently discovered information cannot be promptly determined, the issuance of revised financial statements would necessarily be delayed. In this circumstance, when it appears that the information will require a revision of the statements, appropriate disclosure would consist of notification by the client to persons who are known to be using or who are likely to use the financial statements that they should not be used, and that revised financial statements will be issued and, where applicable, the accountant’s report will be issued as soon as practicable.

.57 The accountant should take whatever steps he or she deems necessary to satisfy himself or herself that the client has made the disclosures specified in paragraph .80 of AR section 100.

.58 If the client refuses to make the disclosures specified in paragraph .81 of AR section 100, the accountant should notify the appropriate personnel at the highest levels within the entity, such as the manager (owner) or the board of directors, of such refusal and of the fact that, in the absence of disclosure by the client, the accountant will take steps as subsequently outlined to prevent further use of the financial statements and, if applicable, the accountant’s report. The steps that can appropriately be taken will depend upon the degree of certainty of the accountant’s knowledge that there are persons who are currently using or who will use the financial statements and, if applicable, the accountant’s report, and who would attach importance to the information, and the accountant’s ability as a practical matter to communicate with them. Unless the accountant’s attorney recommends a different course of action, the accountant should take the following steps to the extent applicable:

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3 See paragraphs 7–10 of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 250-10-50 and paragraphs 23 and 28 of FASB ASC 250-10-45 regarding disclosure of adjustments applicable to prior periods.
4 See paragraphs 7–10 of FASB ASC 250-10-50 and paragraphs 23 and 28 of FASB ASC 250-10-45 regarding disclosure of adjustments applicable to prior periods.
a. Notification to the client that the accountant’s report must no longer be associated with the financial statements.

b. Notification to the regulatory agencies having jurisdiction over the client that the accountant’s report should no longer be used.

c. Notification to each person known to the accountant to be using the financial statements that the financial statements and the accountant’s report should no longer be used. In many instances, it will not be practicable for the accountant to give appropriate individual notification to stakeholders whose identities ordinarily are unknown to him or her; notification to a regulatory agency having jurisdiction over the client will usually be the only practicable way for the accountant to provide appropriate disclosure. Such notification should be accompanied by a request that the agency take whatever steps it may deem appropriate to accomplish the necessary disclosure.

Although a compilation report does not express a conclusion or an opinion on the financial statements, it would seldom be appropriate for an accountant to conclude, simply because his or her responsibilities were limited to a compilation service, that notification of third party users in the absence of notification by the client is not required when the accountant knows that the financial statements should be revised.

.59 The following guidelines should govern the content of any disclosure made by the accountant in accordance with paragraph .82 of AR section 100 to persons other than his or her client:

a. The disclosure should include a description of the nature of the subsequently acquired information and its effect on the financial statements.

b. The information disclosed should be as precise and factual as possible and should not go beyond that which is reasonably necessary to accomplish the purpose mentioned in the preceding subparagraph (a). Comments concerning the conduct or motives of any person should be avoided.

If the client has not cooperated, the accountant’s disclosure need not detail the specific information, but can merely indicate that information has come to his or her attention which the client has not cooperated in attempting to substantiate and that, if the information is true, the accountant believes that the compilation or review report must no longer be used or associated with the financial statements. No such disclosure should be made unless the accountant believes that the financial statements are likely to be misleading and that the accountant’s compilation or review report should not be used.

Management-Use-Only Financial Statements Distributed to Third Parties

.60 Paragraph .27 of AR section 100 states the following:

If the accountant becomes aware that the financial statements [not intended for third-party use] have been distributed to third parties, the accountant should discuss the situation with the client and request that the client have the statements returned. If the client does not comply with this request within a reasonable period of time, the accountant should notify known third parties that the financial statements are not intended for third-party use, preferably in consultation with his or her attorney.

.61 If the accountant determines that the financial statements were given to a third party unintentionally (for example, the client made a mistake or forgot about the restricted nature of the financial statements), then he or she should discuss with the client the restricted nature of the statements and request that the client retrieve all copies from third parties. If the client complies, then there is no need for further action.

.62 However, if the accountant discovers that the client intentionally disregarded the restriction placed on the use of the financial statements, and if the client refuses to retrieve the financial statements, then he or she should notify known third parties that the financial statements are not intended for third-party use. The accountant also might consider how such an action on the client’s part to intentionally disregard the distribution restriction bears on management’s integrity and, as a result, on the performance of any further services for that client.
Some accountants have suggested that the potential risk of third-party distribution is high and, therefore, report on financial statements not intended for third-party use. However, in our profession, there are other restricted use professional services that are offered (for example, agreed-upon procedures engagements and projections). If the accountant obtains a written engagement letter and places a legend indicating the restricted nature of the presentation on each page of the financial statements, then the risk of third-party distribution will likely be lessened.

Practice Tip
Notification of third parties involves legal matters beyond the scope of this manual. Therefore, the accountant might consider consulting with an attorney before taking any action. In order to minimize the risk of a client distributing management-use-only financial statements to third parties, the accountant may consider including language in the engagement letter alerting the client to the fact that if he or she needs financial statements for third-party use that service can be provided separately (see illustrative engagement letter in paragraph .66 of this section.

When to Consider Withdrawing From an Engagement

The accountant may consider withdrawing from an engagement if any of the following conditions exist:

- He or she determines that he or she does not have and cannot obtain sufficient knowledge of the client’s business or industry.
- The client refuses or is unable to provide additional or revised information when the accountant has become aware that information supplied is incorrect, incomplete, or otherwise unsatisfactory.
- Financial statement disclosures were omitted with the intent to mislead.
- The accountant determines that he or she is not independent with respect to the entity, and reviewed financial statements are required.
- The compiled or reviewed financial statements contain departures from GAAP that the client refuses to correct, and the accountant believes the departures were undertaken with the intention of misleading financial statement users.
- There have been substantial limitations in the scope of the engagement, particularly in a review engagement when management does not provide a client representation letter.
- Information comes to the accountant’s attention that contradicts management’s representation that financial statements compiled for management’s use only will not be used by third parties.
Client Acceptance and Continuance Form—Part I

Client: ________________________________
Financial Statement Date: ________________________________

INSTRUCTIONS:

Part I: This form may be completed for all prospective clients for which audit, review, or compilation services are to be performed. The date on the form is ordinarily completed by the in-charge of the engagement and approved by the engagement partner as a basis for initially accepting the client. Part I is typically updated and reviewed annually as a basis for deciding to retain the client.

Part II: Part II is typically completed by the engagement partner and concurring partner to document the firm’s decision to either accept or reject the client.

CLIENT’S LEGAL NAME: ________________________________
ADDRESS: ________________________________
PHONE: ________________________________ FISCAL YEAR END: ________________________________
FEDERAL I.D. NO.: ________________________________ STATE I.D. NO.: ________________________________

1. Describe the nature of the client’s business (and locations, if other than above address):

--------------------------------------------------------------------------------
--------------------------------------------------------------------------------
--------------------------------------------------------------------------------
--------------------------------------------------------------------------------

2. Identify the type of entity (for example, corporation, proprietorship, partnership, or S corporation):

--------------------------------------------------------------------------------
--------------------------------------------------------------------------------
--------------------------------------------------------------------------------
--------------------------------------------------------------------------------
3. List key owners, officers, and directors of the client:

<table>
<thead>
<tr>
<th>Name</th>
<th>Percentage Owned</th>
<th>Position</th>
<th>Family Relationship</th>
</tr>
</thead>
<tbody>
<tr>
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</tbody>
</table>

4. Identify any related businesses or individuals:

<table>
<thead>
<tr>
<th>Name</th>
<th>Nature of Relationship</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

5. Identify the client’s predecessor accountants:

Name:

Address:

Contact Person:

6. Indicate the results of our inquiries of the predecessor accountants regarding the following:
   
   a. Reasons for change of accountant: 
      
   b. Integrity of management: 
      

c. Disagreements on accounting principles and auditing, review, or compilation procedures: 


d. Fee disputes: 


7. Describe the client’s relationship with financial institutions: 


<table>
<thead>
<tr>
<th>Name</th>
<th>Type of A/C’s or Loans</th>
<th>Account Executive</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
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</tbody>
</table>

8. Describe the services our firm is to provide: 


<table>
<thead>
<tr>
<th>Service</th>
<th>How Often?</th>
<th>Report Deadlines</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Monthly</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Quarterly</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Annually</td>
<td></td>
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<tr>
<td></td>
<td>Report</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Deadlines</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Name</th>
<th>Type of A/C’s or Loans</th>
<th>Account Executive</th>
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</thead>
<tbody>
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</tbody>
</table>
Other Services:

Consulting services: ________________________________________________________________

Federal tax returns: ______________________________________________________________

State tax returns: ________________________________________________________________

Payroll tax returns: ______________________________________________________________

Tax returns for principal owners: __________________________________________________

9. Will the financial statements and reports be used for high risk purposes, for example, reports to regulatory agencies, to obtain significant amounts of new credit, to obtain performance bonding, or for purchase of the business? ________________________________________________________________

   Describe the use of the financial statements:

   __________________________________________________

   __________________________________________________

10. Read the latest financial statements and tax returns and indicate any unusual items:

    __________________________________________________

    __________________________________________________

11. Does the client have potential going-concern problems? ________________________________

    If so, describe them:

    __________________________________________________

    __________________________________________________

    __________________________________________________
12. Describe the client’s major sources of financing:


13. State name(s) of third parties contacted concerning management’s and owners’ reputation, attitude, ability, and integrity:


14. Describe any significant engagement performance, accounting, or tax problems with which we should be concerned:


15. Identify the client’s legal counsel:

   Name:
   Address:
   Contact Person:

16. Describe any pending litigation against the client or its principals:


17. Describe the billing arrangements:

18. Describe any potential independence problems with respect to the client:

19. If potential independence problems were identified with respect to the client, how were the problems resolved?

20. Describe any major changes in the above information since our last evaluation of this client. Also describe any other matters that have come to our attention that would have caused us to reject the client had we been aware of them at the time of our initial acceptance of this client:

21. If other matters have been identified with respect to the client, how were the other matters resolved?

Prepared or updated by:
In-Charge

Reviewed by:
Engagement Partner
### Client Acceptance and Continuance Form—Part II

**Client:**

**Financial Statement Date:**

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Is there any reason to doubt the integrity of management (owners)?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Are we aware of any significant disagreements between management (owners) and the predecessor accountant?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Does there appear to be any potential fee collection problems?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Are the client’s needs beyond our capabilities or staffing abilities?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Are we aware of any independence problems that may affect our ability to meet the client’s needs?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Are there high-risk factors related to the engagement that may affect our decision to accept the client?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Is there a potential problem with management (owners) not fully understanding the limitations of the services to be provided (for example, management’s expectation that we will be responsible for the detection of fraud)?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Is the required staffing or expertise necessary for this engagement beyond our capabilities?</td>
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</tr>
</tbody>
</table>

For any “Yes” answers, explain how we plan to mitigate the problem (for example, by assigning more experienced personnel to the engagement, obtaining outside consultants, obtaining a retainer from the client):

---

Acceptance Decision:

Yes ____ No ____

Engagement Partner: __________________________ Date: __________

Concurring Partner: __________________________ Date: __________
.66 Illustrative Engagement Letter for a Compilation of Financial Statements Not Intended for Third Party Use

Mr. Thaddeus Gowers, President
Gowers Drug Stores
1 Main Street
Bedford Falls, New Hampshire 00000

Dear Mr. Gowers:

This letter is to confirm my (our) understanding of the terms and objectives of my (our) engagement and the nature and limitations of the services I (we) will provide. I (We) will perform the following services:

I (We) will compile, from information you provide, the [monthly, quarterly, or other frequency] financial statements of Gowers Drug Stores for the year 20XX.

I (We) will compile the financial statements in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. A compilation is limited to presenting, in the form of financial statements, information that is the representation of management. I (We) will not audit or review the financial statements and, accordingly, will not express an opinion or any other form of assurance on them.

The financial statements will not be accompanied by a report. Based upon my (our) discussions with you, these financial statements are for management’s use only and are not intended for third-party use.

Material departures from [disclose the applicable financial reporting framework, for example, generally accepted accounting principles (GAAP) or other comprehensive basis of accounting (OCBOA)] may exist and the effects of those departures, if any, on the financial statements may not be disclosed. In addition, substantially all disclosures required by [the applicable financial reporting framework] may be omitted. [The accountant may wish to identify known departures.] Notwithstanding these limitations, you represent that you have knowledge about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements that allows you to place the financial information in the proper context. Further, you represent and agree that the use of the financial statements will be limited to members of management with similar knowledge.

The financial statements are intended solely for the information and use of [include list of specified members of management] and are not intended to be and should not be used by any other party.—[optional]

My (Our) engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, I (we) will inform the appropriate level of management of any material errors, of any evidence or information that comes to my (our) attention during the performance of compilation procedures, that fraud may have occurred. In addition, I (we) will report to you any evidence or information that comes to my (our) attention during the performance of my (our) compilation procedures regarding illegal acts that may have occurred unless they are clearly inconsequential.

We are not independent with respect to [name of entity].—[if applicable]

As part of my (our) engagement, I (we) will also (list any nonattest services to be provided, if applicable, such as income tax preparation and bookkeeping services).

You are responsible for

a. making all management decisions and performing all management functions;

b. designating an individual who possesses suitable skill, knowledge, and experience, preferably within senior management, to oversee the services;

c. evaluating the adequacy and results of the services performed;

d. accepting responsibility for the results of the services; and
c. establishing and maintaining internal controls, including monitoring ongoing activities.

The other data accompanying the financial statements are presented only for supplementary analysis purposes and will be compiled from information that is the representation of management, without audit or review, and I (we) will not express an opinion or any other form of assurance on such data.—[if applicable]

Our fees for these services [fill in]

Should you require financial statements for third-party use, I (we) would be pleased to discuss with you the requested level of service. Such engagement would be considered separate and not deemed to be part of the services described in this engagement letter.

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.5

Sincerely yours,

[Signature of accountant]

Accepted and agreed to:

Gowers Drug Stores

Title

Date

[Source: appendix D of AR section 100]

5 Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning “If the foregoing . . .” and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: “This letter sets forth my (our) understanding of the terms and objectives of my (our) engagement . . .”
.67 Illustrative Engagement Letter for a Compilation of Financial Statements

Mr. Thaddeus Gowers, President
Gowers Drug Stores
1 Main Street
Bedford Falls, New Hampshire 00000

Dear Mr. Gowers:

This letter is to confirm my (our) understanding of the terms and objectives of our engagement and the nature and limitations of the services I (we) will provide. I (We) will perform the following services:

I (We) will compile, from information you provide, the annual and interim balance sheets and related statements of income, retained earnings, and cash flows of Gowers Drug Stores for the year 20XX.

I (We) will compile the financial statements and issue an accountant’s report thereon in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. A compilation is limited to presenting, in the form of financial statements, information that is the representation of management. I (We) will not audit or review the financial statements and, accordingly, will not express an opinion or any other form of assurance on them.

My (Our) engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, I (we) will inform the appropriate level of management of any material errors, and of any evidence or information that comes to our attention during the performance of my (our) compilation procedures, that fraud may have occurred. In addition, I (we) will report to you any evidence or information that comes to my (our) attention during the performance of my (our) compilation procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.

As part of my (our) engagement, I (we) will also (list any nonattest services to be performed, if applicable, such as income tax preparation and bookkeeping services).

You are responsible for:

a. making all management decisions and performing all management functions;

b. designating an individual who possesses suitable skill, knowledge, and experience, preferably within senior management, to oversee the services;

c. evaluating the adequacy and results of the services performed;

d. accepting responsibility for the results of the services; and

e. establishing and maintaining internal controls, including monitoring ongoing activities.

If, for any reason, I (we) am (are) unable to complete the compilation of your financial statements, I (we) will not issue a report on such statements as a result of this engagement.

My (Our) fees for these services...

I (We) shall be pleased to discuss this letter with you at any time.

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to me (us).6

Sincerely yours,

[Signature of accountant]

6 Some accountants prefer not to obtain an acknowledgment, in which case their letter would omit the paragraph beginning “If the foregoing . . .” and the spaces for the acknowledgment. The first paragraph of their letter might begin as follows: “This letter sets forth my (our) understanding of the terms and objectives of my (our) engagement . . .”
Accepted and agreed to:
Gowers Drug Stores

Title

Date

[Source: appendix C of AR section 100]
Illustrative Engagement Letter for a Review of Financial Statements

Mr. Thaddeus Gowers, President
Gowers Drug Stores
1 Main Street
Bedford Falls, New Hampshire 00000

Dear Mr. Gowers:

This letter is to confirm my (our) understanding of the terms and objectives of our engagement and the nature and limitations of the services I (we) will provide. I (We) will perform the following services:

I (We) will review the balance sheet of Gowers Drug Stores as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, and issue an accountant’s report thereon in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. I (We) will not perform an audit of such financial statements, the objective of which is the expression of an opinion regarding the financial statements taken as a whole, and, accordingly, I (we) will not express such an opinion on them.

A review consists primarily of inquiries of company personnel and analytical procedures applied to financial data. A review does not contemplate obtaining an understanding of internal control or assessing control risk, tests of accounting records and responses to inquiries by obtaining corroborating evidential matter, and certain other procedures ordinarily performed during an audit. Thus, a review does not provide assurance that I (we) will become aware of all significant matters that would be disclosed in an audit.

My (Our) engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, I (we) will inform the appropriate level of management of any material errors, and of any evidence or information that comes to our attention during the performance of our review procedures, that fraud may have occurred. In addition, I (we) will report to you any evidence or information that comes to my (our) attention during the performance of my (our) review procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.

As part of my (our) engagement, I (we) will also (list any nonattest services to be provided, if applicable, such as income tax preparation and bookkeeping services).

You are responsible for

a. making all management decisions and performing all management functions;

b. designating an individual who possesses suitable skill, knowledge, and experience, preferably within senior management, to oversee the services;

c. evaluating the adequacy and results of the services performed;

d. accepting responsibility for the results of the services; and

e. establishing and maintaining internal controls, including monitoring ongoing activities.

As part of my (our) review procedures, I (we) will require certain written representations from management about the financial statements and matters related thereto.

If, for any reason, I (we) am (are) unable to complete my (our) review of your financial statements, I (we) will not issue a report on such statements as a result of this engagement.

My (Our) fees for these services...

I (We) shall be pleased to discuss this letter with you at any time.
If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

[Signature of accountant]

Accepted and agreed to:

Gowers Drug Stores

Title

Date

[Source: appendix E of AR section 100]

[The next page is 2301.]
AAM Section 2300

Compilation Engagements*

Type of Compilation

.01 Paragraph .04 of AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2), defines a compilation as follows:

A service, the objective of which is to present in the form of financial statements information that is the representation of management (owners) without undertaking to express any assurance on the financial statements.

.02 Compiled financial statements should be accompanied by a report when the accountant has been engaged to compile and report on the financial statements or when the accountant reasonably expects the financial statements to be used by a third party. When the accountant does not reasonably expect the financial statements to be used by a third party, a report is not required.

.03 AR section 100 establishes requirements and provides guidance for the accountant with respect to a compilation engagement

Performance Requirements for a Compilation Engagement

.04 AR section 100 states that in all compilation engagements, the performance standards in paragraph .05 and paragraphs .08–.11 of AR section 100 should be followed.

.05 These performance standards consist of the following:

- Have or obtain a general understanding of the accounting principles and practices of the industry in which the client operates.

  The accountant should have a sufficient understanding of his or her client’s industry to know what the financial statements for an entity in that industry should look like and to be aware of any accounting principles or practices that are unique to that industry. The accountant does not have to be an industry expert, and he or she can obtain this general understanding if he or she does not already possess it (for example, through AICPA guides, nonauthoritative industry guides, and trade publications).

- Have or obtain a general understanding of the client’s business.

  The accountant should have a general understanding of the client’s business transactions, form of its accounting records, stated qualifications of accounting personnel, basis of accounting on which the financial statements are to be presented, and form and content of the financial statements, according to the standard. The purpose of this general understanding is to determine whether it will be necessary for the accountant to perform other accounting services (such as bookkeeping and adjustments) in order to compile the financial statements.

* In February 2009, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 18, Applicability of Statements on Standards for Accounting and Review Services (AICPA, Professional Standards, vol. 2), which amends paragraph .01 of AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2). SSARS No. 18 revises the applicability of the SSARSs so that SSARSs do not apply when the provisions of AU section 722, Interim Financial Information (AICPA, Professional Standards, vol. 1), apply. SSARS No. 18 is effective for compilations and reviews of financial statements for periods beginning after December 15, 2009, with early application permitted. This manual will be updated for SSARS No. 18 in the next edition.
• Obtain additional or revised information if the information supplied by the client appears to be incorrect, incomplete, or otherwise unsatisfactory.

The accountant should never be associated with misleading financial statements.

• Read the compiled financial statements and consider whether they appear to be appropriate in form and free of obvious material error.

This final reading of the financial statements is sometimes called the smell test. The primary purpose of the smell test requirement is to look for mathematical or clerical errors, presentation errors (for example, incorrect titles on the financial statements), and others.

Limitations of a Compilation Engagement

.06 Paragraph .12 of AR section 100 indicates that a compilation differs significantly from a review or an audit of financial statements. A compilation does not contemplate performing inquiry, analytical procedures, or other procedures performed in a review. Additionally, a compilation does not contemplate obtaining an understanding of the entity’s internal control; assessing fraud risk; tests of accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Therefore, a compilation does not provide a basis for expressing any level of assurance on the financial statements being compiled.

Performance Requirements

.07 In order to perform a compilation, the accountant should

• establish an understanding with the client (see paragraphs .29-.40 of section 2200). If the engagement is to compile financial statements not expected to be used by a third party and the accountant does not report on the financial statements, then the understanding should be documented through the use of an engagement letter.

• have or obtain a general understanding of the accounting principles and practices of the industry in which the client operates.

• have or obtain a general understanding of the client’s business.

• obtain additional or revised information if the information supplied by the client appears to be incorrect, incomplete, or otherwise unsatisfactory.

• read the compiled financial statements and consider whether they appear to be appropriate in form and free of obvious material error.

Reporting Requirements

.08 Paragraphs .13-.23 of AR section 100 establish requirements and provide guidance when the accountant submits financial statements to a client that will be used by a third party or if he or she reasonably expects that they might be used by a third party.

.09 Illustrative reports for compiled financial statements are included in section 2610.

Third Parties

.10 In deciding whether the financial statements are, or reasonably might be, expected to be used by a third party, the accountant may rely on management’s representation without further inquiry; unless information comes to his or her attention that contradicts management’s representation. Paragraph .04 of AR section 100 defines third parties as all persons, including those charged with governance, except for members of management.
.11 This is a definition by exception. In other words, the starting point for determining who is a third party is that all parties are third parties, with the exception of certain members of management. Those certain members of management would be those members who are knowledgeable about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements. In order to not be considered a third party, the person or persons could meet the following two requirements:

- He or she is a member of management.
- He or she is knowledgeable enough about the business to put the information in the proper context.

.12 In exhibit 2300-1, “Third Parties,” circle C represents all potential users of an entity’s financial statements (banks, bonding companies, creditors, shareholders, vendors, customers, and so on), and circle B represents all members of management. All users in circle C would be considered third parties. In addition, members of management in circle B—those without the requisite knowledge of the client’s business that would allow them to place the information contained in the financial statements in the proper context—also would be considered third parties. Compiled financial statements which do not include a report should be restricted to those parties in circle A—those members of management who have the requisite knowledge of the business.

Exhibit 2300-1—Third Parties

.13 Although some judgment is involved in making this determination, the accountant may rely on management’s representation that they have the necessary knowledge of the business to put the information in the proper context.

.14 This definition does not mean that certain members of management have to be thoroughly knowledgeable about technical accounting principles and procedures. Instead, management might be knowledgeable about the nature of the services the accountant is providing and understand the procedures and assumptions he or she is using. Consider these examples of third parties:

- ABC Company is a small, closely held business, owned and managed by its sole shareholder, John. In this situation, absent evidence to the contrary, John has the requisite knowledge of his business and would not be considered a third party.
- KLM Company is a small, closely held business, managed by one of its ten shareholders, Jane (the other nine shareholders live out of state and are not involved in the management of the business). In this situation, absent evidence to the contrary, Jane has the requisite knowledge of the business and
would not be considered a third party. The other nine shareholders, however, would be considered third parties.

- XYZ Company is a small, closely held business. The management team consists of a president, Joe; controller, Mary; operations manager, Sue; and sales manager, Jim. Joe, Mary, and Sue are all involved in the financial operation of the company and are knowledgeable about the accounting principles and practices being used. Jim, on the other hand, has no finance background and is not involved in the financial operation of the company. In this example, Joe, Mary, and Sue would not be considered third parties. Jim, although he is a member of management, does not have the requisite knowledge of the accounting practices of the business and would be considered a third party.

.15 Note that those members of management that are considered third parties (Jim, in the preceding example) could be “brought into the loop” or removed from third party status. Removing management members from third-party status would occur by educating those members of management about the accounting principles and practices of the business, thereby allowing them to place the information in the proper context. This education could be accomplished by other members of management or by the accountant.

Documentation Requirement

.16 AR section 100 does not discuss documentation for a compilation engagement except in the case of the engagement letter in an engagement to compile financial statements not expected to be used by a third party or when evidence or information comes to the accountant’s attention during the performance of compilation procedures that fraud or an illegal act may have occurred. Although not required, including the type of documentation noted in the following list may be helpful from a risk management and quality control perspective:

- Engagement letter for all compilation engagements
- Trial balance information to bridge the client’s records to the compiled financial statements
- Notes on how incorrect, incomplete, or unsatisfactory matters, if any, were resolved
- If required by firm policy, compilation work program, procedural checklists, and disclosure checklists

Practice Tip

Remember—all relevant information is potentially subject to discovery in a lawsuit, regardless of the storage medium.

.17 Compilation Engagement Program

<table>
<thead>
<tr>
<th>Client:</th>
<th>Balance Sheet Date:</th>
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<tr>
<td>Completed by:</td>
<td>Date Completed:</td>
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<table>
<thead>
<tr>
<th>Procedure</th>
<th>Completed by or N/A</th>
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<tbody>
<tr>
<td>1. Prepare or update the client acceptance and continuance form.</td>
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</table>

1 AR section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2), requires documentation of the understanding with the client in the form of a written engagement letter for a management-use-only compilation (if a compilation report is not being issued). See paragraphs .29–.33 of section 2200 for more detailed discussion of matters included in written engagement letters.
### Procedure

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<table>
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<tr>
<td><strong>2.</strong> Consider whether the firm is independent. If not independent, the compilation report should be modified to indicate that fact.</td>
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<tr>
<td><strong>3.</strong> Establish an understanding with the client, preferably in writing, regarding the nature of the services to be performed. Include a copy of the engagement letter or memorandum describing oral arrangements.</td>
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<td><strong>4.</strong> If the engagement was originally intended to be an audit or a review, document the appropriateness of the decision to step-down.</td>
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<td><strong>5.</strong> Acquire the necessary knowledge and understanding of the following:</td>
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<tr>
<td></td>
<td>a. Accounting principles and practices of the industry</td>
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<td></td>
<td>b. Nature of the client’s business transactions, form of accounting records, stated qualifications of the accounting personnel, accounting basis to be used, and form and content of the financial statements</td>
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<tr>
<td><strong>6.</strong> Consider the necessity to perform any other accounting services to enable compilation of the financial statements.</td>
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<td><strong>7.</strong> If there is any indication that information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory, obtain additional or revised information.</td>
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<td><strong>8.</strong> Draft and read the financial statements and consider whether:</td>
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<td></td>
<td>a. the financial statements include all required disclosures, unless substantially all disclosures are omitted.</td>
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<td></td>
<td>b. financial statements prepared in accordance with an other comprehensive basis of accounting (OCBOA) present proper OCBOA titles and disclose the basis of accounting either in the notes or in the compilation report.</td>
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<td></td>
<td>c. the financial statements are appropriate in form.</td>
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<td></td>
<td>d. the financial statements are free of obvious mathematical or clerical error.</td>
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<td></td>
<td>e. the financial statements are free of obvious measurement departures from generally accepted accounting principles (GAAP) or OCBOA.</td>
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<tr>
<td><strong>9.</strong> Draft the accountant’s report.</td>
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<tr>
<td><strong>10.</strong> If the financial statements omit substantially all disclosures required by GAAP or OCBOA, add an additional paragraph to the report disclosing the omission.</td>
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<tr>
<td><strong>11.</strong> If the financial statements contain a departure from GAAP or OCBOA, including either a measurement or disclosure departure:</td>
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<tr>
<td></td>
<td>a. Revise the financial statements or modify the report to indicate the departure.</td>
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<td></td>
<td>b. If the financial statements are not revised, consider whether modification of the report is adequate to indicate the deficiencies in the financial statements.</td>
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<td></td>
<td>c. If modification of the report is not considered adequate, consider withdrawing from the engagement.</td>
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<tr>
<td><strong>12.</strong> If supplementary data accompanies the financial statements, consider referring to the other data in the compilation report or issuing a separate report on the other data.</td>
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(continued)
<table>
<thead>
<tr>
<th>Procedure</th>
<th>Completed by or N/A</th>
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<tbody>
<tr>
<td>13. Include a reference to the report on each page of the financial</td>
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<tr>
<td>statements and supplementary data.</td>
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<tr>
<td>14. Document any other procedures performed or unusual problems and their</td>
<td></td>
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<tr>
<td>resolution.</td>
<td></td>
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<tr>
<td>15. Determine that all required forms and checklists have been completed.</td>
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<tr>
<td>16. Determine that all questions, exceptions, or notes, if any, posed</td>
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<tr>
<td>during the work have been followed up and resolved, and review notes</td>
<td></td>
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<tr>
<td>and “to do” lists have been removed from the working papers.</td>
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<tr>
<td>17. Date the report as of the date the compilation was completed.</td>
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</table>

**Compilation of Financial Statements Flowchart**

.18 During the initial development of Statement on Standards for Accounting and Review Services (SSARS) No. 8, Amendment to Statement on Standards for Accounting and Review Services No. 1 Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2, AR sec. 100), the members of the Accounting and Review Services Committee designed a flowchart to help guide their discussion about the proposed changes in AR section 100. That flowchart, which first appeared in SSARS No. 8, is also currently available in appendix A, “Compilation of Financial Statements,” of AR section 100. We are including it here with the addition of explanatory notes following.
1 **Submission of financial statements.** Presenting to a client or third parties financial statements that the accountant has prepared either manually or through the use of computer software.

2 **Compilation of financial statements.** A service, the object of which is to present in the form of financial statements information that is the representation of management (owners) without undertaking to express any assurance on the financial statements.

3 **Management.** The person(s) responsible for achieving the objectives of the entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management is responsible for the financial statements, including designing, implementing, and maintaining effective internal control over financial reporting.

4 **Those charged with governance.** The person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. In some cases, those charged with governance are responsible for approving the entity’s
financial statements (in other cases, management has this responsibility). In some entities, governance is a collective responsibility that may be carried out by a board of directors, a committee of the board of directors, a committee of management, partners, equivalent persons, or some combination thereof. Those charged with governance are specifically excluded from management, unless they perform management functions.

5 Third parties. All persons, including those charged with governance, except for members of management parties except for management who are generally knowledgeable and understand the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements.

6 The engagement letter should include the following matters:

- A description of the nature and limitations of the services to be performed
- A statement that a compilation is limited to presenting in the form of financial statements information that is the representation of management
- A statement that the financial statements have not been audited or reviewed
- A statement that no opinion or any other form of assurance on the financial statements will be provided
- An acknowledgement that management has knowledge about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements
- An acknowledgement of management’s representation and agreement that the financial statements will not be used by third parties
- A statement that the engagement cannot be relied upon to disclose errors, fraud, or illegal acts

The engagement letter should also include the following additional matters, if applicable:

- A statement that material departures from generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting (OCBOA) may exist and the effects of those departures on the financial statements may not be disclosed
- A statement that substantially all disclosures (and the statement of comprehensive income and statement of cash flows, if applicable) required by GAAP or OCBOA may be omitted
- A statement that the accountant is not independent
- A reference to any supplementary information that may be included

.19 Management-Use-Only Compilation Engagement Checklist

<table>
<thead>
<tr>
<th>Client:</th>
<th>Balance Sheet Date:</th>
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<table>
<thead>
<tr>
<th>Procedure</th>
<th>Completed by or N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Prepare or update the Client Acceptance Form.</td>
<td></td>
</tr>
<tr>
<td>2. Consider whether the firm is independent. If not independent, the engagement letter should be modified to indicate that fact.</td>
<td></td>
</tr>
<tr>
<td>3. Establish an understanding with the client, in writing, regarding the following and include a copy of the engagement letter in the working papers:</td>
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<tr>
<td>Procedure</td>
<td>Completed by or N/A</td>
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</tr>
<tr>
<td>a. Nature and limitations of the services</td>
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</tr>
<tr>
<td>b. A compilation is limited to presenting in the form of financial statements information that is the representation of management</td>
<td></td>
</tr>
<tr>
<td>c. The financial statements will not be audited or reviewed</td>
<td></td>
</tr>
<tr>
<td>d. No opinion or any other form of assurance on the financial statements will be provided</td>
<td></td>
</tr>
<tr>
<td>e. Management has knowledge of the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements</td>
<td></td>
</tr>
<tr>
<td>f. Management representation that financial statements are not to be used by third parties</td>
<td></td>
</tr>
<tr>
<td>g. Engagement cannot be relied upon to disclose errors, fraud, or illegal acts, and we will inform appropriate level of management of any material errors, of any evidence or information that comes to my (our) attention during the engagement, that fraud or an illegal act may have occurred, unless clearly inconsequential</td>
<td></td>
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</table>

4. If the engagement was originally intended to be another type of engagement, document the appropriateness of the decision to change the engagement.

5. Acquire the necessary knowledge and understanding of the following:
   a. Accounting principles and practices of the industry
   b. Nature of the client’s business transactions, form of accounting records, stated qualifications of the accounting personnel, accounting basis to be used, and form and content of the financial statements

6. Consider the necessity to perform any other accounting services to enable compilation of the financial statements.

7. If there is any indication that information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory, obtain additional or revised information.

8. Draft and read the financial statements and consider whether
   a. the financial statements are appropriate in form.
   b. the financial statements are free of obvious mathematical or clerical error.

9. Include a legend on each page of the financial statements and supplementary data indicating the restricted nature of the presentation.

10. Document any other procedures performed or unusual problems and their resolution.

11. Determine that all required forms and checklists have been completed.

12. Determine that all questions, exceptions, or notes, if any, posed during the work have been followed up and resolved, and review notes and “to do” lists have been removed from the working papers.
AAM Section 2400

Review Engagements*

Overview

.01 Paragraph .04 of AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2), defines a review of financial statements as follows:

A service, the objective of which is to express limited assurance that there are no material modifications necessary that should be made to the financial statements in order for the statements to be in conformity with generally accepted accounting principles (GAAP).

.02 The following performance requirements are applicable to a review engagement:

• Establish an understanding with the entity, preferably in writing, regarding the nature and limitations of the services to be performed and a description of the report the accountant expects to render (See paragraphs .29–.40 of section 2200 for a discussion of engagement letters).

• Have, or obtain, knowledge of the accounting principles and practices of the entity’s industry and a general understanding of certain matters related to the entity’s business.

• Apply analytical procedures to the financial statements to identify and provide a basis for other review procedures and inquiry about the relationships and individual items that appear to be unusual and that may indicate a material misstatement.

• Take certain actions when the accountant becomes aware that information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory and consider the effect of these matters on his or her review report.

• Obtain a representation letter from management.

• Document certain items in accordance with the requirements and guidance provided in paragraphs .43–.45 of AR section 100.

Knowledge of Accounting Principles and Practices of the Industry

.03 AR section 100 states that the accountant should have knowledge of the accounting principles and practices of the industry in which the entity operates.

.04 The purpose of having that knowledge in a review is to assist the accountant in constructing inquiries and analytical procedures adequate to provide a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with GAAP.

.05 AR section 100 states that the accountant should possess or obtain certain knowledge about the entity whose financial statements are under review.

* In February 2009, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 18, Applicability of Statements on Standards for Accounting and Review Services (AICPA, Professional Standards, vol. 2), which amends paragraph .01 of AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2). SSARS No. 18 revises the applicability of the SSARSs so that SSARSs do not apply when the provisions of AU section 722, Interim Financial Information (AICPA, Professional Standards, vol. 1), apply. SSARS No. 18 is effective for compilations and reviews of financial statements for periods beginning after December 15, 2009, with early application permitted. This manual will be updated for SSARS No. 18 in the next edition.
The accountant who performs a review should have a general understanding of the following:

- Entity’s organization
- Operating characteristics of that organization
- Nature of the entity’s assets and liabilities
- Nature of the entity’s revenues and expenses

In order to obtain this understanding, the accountant would need a general knowledge of the entity’s

- products and services.
- production, distribution, and compensation methods.
- operating locations.
- material transactions with related parties.

Inquiries and Analytical Procedures

In order to obtain a reasonable basis for the expression of limited assurance, the accountant must apply analytical procedures to the financial statements and make inquiries of management and, when deemed appropriate, other company personnel. The accountant performs these procedures to obtain a basis for concluding that there are no material modifications that should be made to the financial statements in order for them to be in conformity with GAAP. The specific inquiries made and the analytical and other procedures performed should be tailored to the engagement based on the accountant’s knowledge of the entity’s business. For example, if the accountant becomes aware of a significant change in the entity’s operations, the accountant may consider making additional inquiries, employing additional analytical procedures, or both. Professional literature does not indicate how many procedures have to be performed in a given engagement to achieve its reporting objective. That is a matter of professional judgment. The extent of the total knowledge the accountant possesses about an entity and the industry in which it operates is the basis for planning the extent of procedures to be performed.

Analytical Procedures

Paragraph .31 of AR section 100 states that the accountant must apply analytical procedures to the financial statements. The purpose of analytical procedures is to identify and provide a basis for inquiry about the relationships and individual items that appear to be unusual and that may indicate a material misstatement. Analytical procedures include the following:

- Developing expectations by identifying and using plausible relationships that are reasonably expected to exist based on the accountant’s understanding of the entity and the industry in which the entity operates
- Comparing recorded amounts, or ratios developed from recorded amounts, to expectations developed by the accountant

Appendix I of AR section 100 contains examples of analytical procedures an accountant may consider performing when conducting a review of financial statements.

A list of examples of analytical procedures for a review engagement is included in paragraph .46 that follows in this section of the manual.

Expectations developed by the accountant in performing analytical procedures in connection with a review of financial statements ordinarily are less encompassing than those developed in an audit. Also in a review, the accountant ordinarily is not required to corroborate management’s responses with other evidence. However, the accountant should consider the reasonableness and consistency of management’s responses in
light of the results of other review procedures and the accountant’s knowledge of the entity’s business and the industry in which it operates.

.13 A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue to exist in the absence of known conditions to the contrary.

.14 In applying analytical procedures in a review engagement, the accountant may achieve both effectiveness and efficiency by using the following approach:

• Identify immaterial account balances or classes of transactions. Apply analytical procedures to them, if needed.
• Identify account balances or classes of transactions to which other accounting services (bookkeeping or payroll services, for example) have been applied. Consider the evidence that has been gathered and whether any material errors are likely to remain. If there is already sufficient evidence for those account balances or classes of transactions to reduce the risk of material misstatement to a moderate level, consider whether applying analytical procedures is needed.
• For the remaining account balances and classes of transactions, develop expectations (for example, using historical trends adjusted for known changes) for them. Note, however, that AR section 100 does not require a formal process of developing and documenting expectations.
• Consider how close the existing account balance or class of transaction comes to the expectation developed in the previous step. If the differences are small, no additional evidence may be needed.
• If the differences are not in accordance with the accountant’s expectations, material errors could exist. Inquire about valid business reasons for the difference. If the results of inquiry are plausible and agree with other evidence, no additional evidence may be needed.
• If additional evidence is needed, apply other analytical procedures or obtain other suitable evidence.

Inquiries and Other Review Procedures

.15 The following are inquiries the accountant should consider making and other review procedures the accountant should consider performing when conducting a review of financial statements:

a. Inquiries to members of management who have responsibility for financial and accounting matters concerning (see appendix B of AR section 100):

(1) Whether the financial statements have been prepared in conformity with generally accepted accounting principles consistently applied
(2) The entity’s accounting principles and practices and the methods followed in applying them and procedures for recording, classifying, and summarizing transactions, and accumulating information for disclosure in the financial statements
(3) Unusual or complex situations that may have an effect on the financial statements
(4) Significant transactions occurring or recognized near the end of the reporting period
(5) The status of uncorrected misstatements identified during the previous engagement
(6) Questions that have arisen in the course of applying the review procedures
(7) Events subsequent to the date of the financial statements that could have a material effect on the financial statements
(8) Their knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, for example, communications received from employees, former employees, or others
(9) Significant journal entries and other adjustments
(10) Communications from regulatory agencies

b. Inquiries concerning actions taken at meetings of shareholders, board of directors, committees of the board of directors, or comparable meetings that may affect the financial statements
c. Reading the financial statements to consider, on the basis of information coming to the accountant’s attention, whether the financial statements appear to conform with GAAP
d. Obtaining reports from other accountants, if any, who have been engaged to audit or review the financial statements of significant components of the reporting entity, its subsidiaries, and other investees

.16 Appendix B of AR section 100 contains illustrative inquiries for a review engagement. However, these illustrative inquiries are not intended to serve as a program or checklist in the conduct of a review. The inquiries to be made in a review engagement are a matter of the accountant’s professional judgment. Specific inquiries should be tailored to the client, based on the accountant’s understanding of the client’s business and the industry in which it operates. Appendix B of AR section 100 is included in paragraph .46 of this section.

.17 Overall, the purpose of the inquiries and analytical procedures is to provide the accountant with sufficient evidence to support the accountant’s conclusion that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework. AR section 100 does not specify the extent of procedures that have to be performed in order for the accountant to have accumulated sufficient evidence. The extent and type of procedures performed is a matter of professional judgment.

.18 Paragraph .42 of AR section 100 allows modification of inquiry and analytical procedures. For example, the accountant may have acquired knowledge about the entity in the performance of audits of the entity’s financial statements, compilation of the entity’s financial statements, or other accounting services (such as bookkeeping services). This acquired knowledge may be sufficient to reduce the extent of inquiries and analytical procedures, although the accountant would still have the same degree of responsibility with respect to the financial statements (concluding that no material modifications should be made to the financial statements).

Analytical Procedures in Initial Review Engagements

.19 Accountants often question how to apply analytical procedures on initial review engagements. For example, how can the accountant evaluate the results of procedures applied for the current year if he or she is unsure whether amounts are comparable with prior years or if the company is newly formed? As stated in the previous section, paragraph .42 of AR section 100 states:

Knowledge acquired in the performance of audits of the entity’s financial statements, compilation of the financial statements, or other accounting services may result in modification of the review procedures described. However, such modification would not reduce the degree of responsibility the accountant assumes with respect to the reviewed financial statements.

.20 This allows the accountant to modify his or her inquiries and analytical procedures based on knowledge acquired in the performance of other services. Although AR section 100 does not cite initial engagements as a situation in which the accountant may choose to modify his or her inquiries and analytical procedures, it is reasonable to assume that these procedures could be modified in initial engagements.

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1 The financial statements of the reporting entity ordinarily include an accounting for all significant components, such as unconsolidated subsidiaries and investees. If other accountants are engaged to audit or review the financial statements of such components, the accountant will require reports from the other accountants as a basis, in part, for the accountant’s review report with respect to the review of the financial statements of the reporting entity. The accountant may decide to make reference to the work of other accountants in the accountant’s review report on the financial statements. If such reference is made, the report should indicate the magnitude of the portion of the financial statements audited or reviewed by the other accountants.
In initial review engagements, the accountant may have to rely on other sources of evidence. For example, the accountant may have to rely on making additional inquiries. Or, the accountant may have already compiled the financial statements, or may have provided other accounting or bookkeeping services for the client. In these cases, the accountant may rely on knowledge gained from these other services to supplement the analytical procedures that can be performed because of insufficient history. Also, the accountant’s analytical procedures may also consist of comparisons with results for similar clients or to industry statistics, and of analysis of the interrelationships between accounts in these circumstances.

When the Results of Analytical Procedures Are Not In Accordance With the Accountant’s Expectations

When results of analytical procedures are not in accordance with the accountant’s expectations, paragraph .31 of AR section 100 states that the accountant should perform additional procedures deemed necessary to achieve limited assurance that no material modifications are necessary to conform the financial statements to GAAP. Sometimes inquiries and analytical procedures are sufficient. However, in many cases, the accountant combines additional inquiry or analytical procedures with preparing other accounting schedules or analyses to explain fluctuations.

An illustrative ratio analysis worksheet is included in paragraph .45 that follows in this section of the manual, and an illustrative analytical procedures comparative report is included in paragraph .46.

Awareness Concerning Information Supplied

Paragraph .31 of AR section 100 states that during the performance of the review procedures, “…the accountant may become aware that information coming to his or her attention is incorrect, incomplete, or otherwise unsatisfactory or that fraud or an illegal act may have occurred. The accountant should request that management consider the effect of the matter on the financial statements. Additionally, the accountant should consider the effect of these matters on his or her review report. In circumstances where the accountant believes the financial statements are materially misstated, the accountant should perform additional procedures deemed necessary to achieve limited assurance...”

If the accountant is unable to perform the inquiry and analytical procedures he or she considers necessary to achieve limited assurance contemplated by a review, the accountant’s review will be incomplete. Under these circumstances, the accountant will not have attained the objective of the review and accordingly cannot conclude as to whether the financial statements are not materially misstated.

Paragraph .51 of AR section 100 also states that “when an accountant is unable to perform the inquiry and analytical procedures he or she considers necessary ... the review will be incomplete.” A review that is incomplete is not an adequate basis for issuing a review report. In such a situation, the accountant should also consider whether it is appropriate to issue a compilation report on the financial statements.

Representation Letters

Written representations are required from management for all financial statements and periods covered by the accountant’s review report. The specific written representations obtained by the accountant will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. In connection with the review of the financial statements presented in accordance with GAAP, specific representations should relate to the following matters:

- Management’s acknowledgement of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with GAAP

2 Specific representations also are applicable to financial statements presented in conformity with a comprehensive basis of accounting other than generally accepted accounting principles. The specific representations to be obtained should be based on the nature and basis of representation of the financial statements being reviewed.
• Management’s belief that the financial statements are fairly presented in conformity with generally accepted accounting principles
• Management’s acknowledgement of its responsibility to prevent and detect fraud
• Knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, including any communications received from employees, former employees, or others
• Management’s full and truthful response to all inquiries
• Completeness of information
• Information concerning subsequent events

.28 Like the inquiries and analytical procedures in a review engagement, the management representation letter ordinarily should be tailored to the client based on the accountant’s knowledge of the client’s business and the industry in which it operates. Additional representations may be added to the letter, especially if the client operates in a specialized industry (for example, construction contractors, homeowners associations, and not-for-profit organizations). These additional representations may be found in AICPA Industry Audit and Accounting Guides which can be obtained by contacting AICPA Service Center Operations at (888) 777-7077.

.29 The management representation letter should be addressed to the accountant. Management’s representations set forth in the management representation letter should be made as of the date of the accountant’s review report because the accountant is concerned with events occurring through the date of the report that may require adjustments to or disclosure in the financial statements. The letter should be signed by those members of management whom the accountant believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered in the representation letter. Normally the CEO and CFO or others with equivalent positions in the entity should sign the representation letter. If the current management was not present during all the periods covered by the accountant’s report, the accountant should, nevertheless, obtain written representations from current management on all such periods.

.30 An illustrative management representation letter is provided in appendix F of AR section 100 and is included in paragraph .44 that follows in this section of the manual.

.31 There are circumstances in which an accountant should consider obtaining an updating representation letter from management (for example, the accountant obtains a management representation letter after completion of inquiry and analytical review procedures but does not issue his or her review report for a significant period of time thereafter, or a material subsequent event occurs after the completion of inquiry and analytical review procedures, including obtaining the original management representation letter, but before the issuance of the report on the reviewed financial statements). In addition, if a predecessor accountant is requested by a former client to reissue his or her report on the financial statements of a prior period, and those financial statements are to be presented on a comparative basis with reviewed financial statements of a subsequent period, the predecessor accountant should obtain an updating representation letter from the management of the former client. The updating management representation letter should state (a) whether any information has come to management’s attention that would cause management to believe that any of the previous representations should be modified and (b) whether any events have occurred subsequent to the balance sheet date of the latest financial statements reported on by the accountant that would require adjustment to or disclosure in those financial statements.

.32 An illustrative updating management representation letter is provided in appendix G of AR section 100 and is included in paragraph .48 that follows in this section of the manual.

Documentation

.33 The accountant should prepare documentation in connection with a review of financial statements, the form and content of which should be designed to meet the circumstances of the particular engagement.
Documentation is the principal record of the review procedures performed and the conclusions reached by the accountant in performing the review. However, an accountant would not be precluded from supporting his or her review report by other means in addition to the review documentation. Such other means might include written documentation contained in other engagement (for example, compilation) files or quality control files (for example, consultation files) and in limited situations, oral explanations. Oral explanations should be limited to those situations where the accountant finds it necessary to supplement or clarify information contained in the documentation. Oral explanations should not be the principal support for the work performed or the conclusions reached.

.34 Paragraph .44 of AR section 100 states that it is not possible to specify the form or content of the documentation the accountant should prepare because of the different circumstances in individual engagements. However, the documentation should include any findings or issues that in the accountant’s judgment are significant, for example, the results of review procedures that indicate the financial statements could be materially misstated, including actions taken to address such findings, and the basis for the final conclusions reached.

.35 Paragraph .45 of AR section 100 states that the documentation of the inquiry and analytical procedures should include the following:

- The matters covered in the accountant’s inquiry procedures
- The analytical procedures performed
- The expectations as discussed in paragraph .36 of AR section 100, where significant expectations are not otherwise readily determinable from the documentation of the work performed, and factors considered in the development of those expectations
- Results of the comparison of the expectations to the recorded amounts or ratios developed from recorded amounts
- Any additional procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures
- Unusual matters that the accountant considered during the performance of the review procedures, including their disposition
- Communications, whether oral or written, to the appropriate level of management regarding fraud or illegal acts that come to the accountant’s attention
- The representation letter

.36 In addition, many accountants include some or all of the following in their working papers:

- Engagement letter
- Checklist or memorandum describing the accountant’s knowledge of the client’s business and industry
- Checklist, work program, and results of analytical procedures in support of inquiries and analytical procedures, including names of persons responding to inquiries
- Support for data in the notes to the financial statements
- Discussion of unusual matters encountered
- Compilation working papers, if the financial statements required compilation prior to review
- Copies of reports from other accountants who have audited or reviewed a subsidiary
- Reasons for a step-down from an audit, if applicable
Additional Guidance

.37 AR exhibit A, Analytical Procedures in a Review Engagement (AICPA, Professional Standards, vol. 2), provides guidance for accountants that may help them understand certain requirements related to the use of analytical procedures in review engagements and how the use of analytical procedures can be documented in those engagements.

.38 Accountants may also refer to the AICPA Practice Aid Review Engagements—New and Expanded Guidance on Analytical Procedures and Inquiries and Other Procedures (product no. 006618). The practice aid clarifies certain existing Statements on Standards for Accounting and Review Services (SSARSs), suggests ways of implementing existing and new standards in special circumstances, and provides practical guidance to help implement the changes to AR section 100.
### .39 Review Engagement Program

<table>
<thead>
<tr>
<th>Client:</th>
<th>Balance Sheet Date:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Completed by:</td>
<td>Date Completed:</td>
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</table>

<table>
<thead>
<tr>
<th>Procedure</th>
<th>Completed by or N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Prepare or update the client acceptance and continuance form.</td>
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<tr>
<td>2. Consider whether the firm is independent. If not independent, a review engagement cannot be performed.</td>
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<tr>
<td>3. Establish an understanding with the client, preferably in writing, regarding the nature of the services to be performed. Include a copy of the engagement letter or memorandum describing oral arrangements.</td>
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<tr>
<td>4. If the engagement was originally intended to be an audit, document the appropriateness of the decision to step-down.</td>
<td></td>
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<tr>
<td>5. Acquire the necessary knowledge and understanding of:</td>
<td></td>
</tr>
<tr>
<td>a. Accounting principles and practices of the industry.</td>
<td></td>
</tr>
<tr>
<td>b. Nature of the client’s business transactions, form of accounting records, stated qualifications of the accounting personnel, accounting basis to be used, and form and content of the financial statements.</td>
<td></td>
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<tr>
<td>6. Consider the necessity to perform any other accounting services to enable review of the financial statements.</td>
<td></td>
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<tr>
<td>7. Apply analytical procedures to the financial statements to identify and provide a basis for inquiry about relationships and individual items that appear to be unusual and that may indicate a material misstatement. Consider performing the analytical procedures described in paragraph .46 of section 2400 of the AICPA Audit and Accounting Manual.</td>
<td></td>
</tr>
<tr>
<td>8. Inquire of members of management having responsibility for financial and accounting matters concerning the following:</td>
<td></td>
</tr>
<tr>
<td>a. Whether the financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting (OCBOA) consistently applied.</td>
<td></td>
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<tr>
<td>b. The entity’s accounting principles and practices and the methods followed in applying them and procedures for recording, classifying, and summarizing transactions, and accumulating information for disclosure in the financial statements.</td>
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<tr>
<td>c. Unusual or complex situations that may have an effect on the financial statements.</td>
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<tr>
<td>d. Significant transactions occurring or recognized near the end of the reporting period.</td>
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<tr>
<td>e. The status of uncorrected misstatements identified during the previous engagement.</td>
<td></td>
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<tr>
<td>f. Questions that have arisen in the course of applying the review procedures.</td>
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</table>

(continued)
<table>
<thead>
<tr>
<th>Procedure</th>
<th>Completed by or N/A</th>
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<tbody>
<tr>
<td>g. Events subsequent to the date of the financial statements that could have a material effect on the financial statements.</td>
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<tr>
<td>h. Their knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, for example, communications received from employees, former employees, or others.</td>
<td></td>
</tr>
<tr>
<td>i. Significant journal entries and other adjustments.</td>
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<tr>
<td>j. Communications from regulatory agencies.</td>
<td></td>
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<tr>
<td>9. Make inquiries concerning actions taken at meetings of shareholders, board of directors, committees of the board of directors, or comparable meetings that may affect the financial statements.</td>
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<tr>
<td>10. Read the financial statements to consider whether, on the basis of information coming to the accountant’s attention:</td>
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<tr>
<td>a. the financial statements appear to conform with GAAP or an OCBOA.</td>
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<tr>
<td>b. financial statements prepared in accordance with an OCBOA present proper OCBOA titles and disclose the basis of accounting in the notes or in the review report.</td>
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<tr>
<td>c. the financial statements are appropriate in form.</td>
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<tr>
<td>d. the financial statements are free from obvious mathematical or clerical error.</td>
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<tr>
<td>11. Obtain reports from other accountants, if any, who have been engaged to audit or review the financial statements of significant components of the reporting entity, its subsidiaries, and other investees.</td>
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<tr>
<td>12. If there is any indication that information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory, obtain additional or revised information.</td>
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<tr>
<td>13. Draft the accountant’s report.</td>
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<tr>
<td>14. If the financial statements contain a departure from GAAP or OCBOA, including either a measurement or disclosure departure:</td>
<td></td>
</tr>
<tr>
<td>a. revise the financial statements or modify the report to indicate the departure.</td>
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<tr>
<td>b. if the financial statements are not revised, consider whether modification of the report is adequate to indicate the deficiencies in the financial statements.</td>
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<tr>
<td>c. if modification of the report is not considered adequate, consider withdrawing from the engagement.</td>
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<tr>
<td>15. Obtain a representation letter.</td>
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<tr>
<td>16. If supplementary data accompanies the financial statements, modify the report in accordance with paragraph .83 of AR section 100.</td>
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<tr>
<td>17. Include a reference to the report on each page of the financial statements and supplementary data.</td>
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<tr>
<td>18. Document the following:</td>
<td></td>
</tr>
<tr>
<td>a. The matters covered in the accountant’s inquiry procedures</td>
<td></td>
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<tr>
<td>Procedure</td>
<td>Completed by or N/A</td>
</tr>
<tr>
<td>--------------------------------------------------------------------------</td>
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<tr>
<td>b. The analytical procedures performed</td>
<td></td>
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<tr>
<td>c. The expectations as discussed in paragraph .36 of AR section 100, where significant expectations are not otherwise readily determinable from the documentation of the work performed and factors considered in the development of those expectations</td>
<td></td>
</tr>
<tr>
<td>d. Results of the comparison of the expectations to the recorded amounts or ratios developed from recorded amounts</td>
<td></td>
</tr>
<tr>
<td>e. Any additional procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures</td>
<td></td>
</tr>
<tr>
<td>f. Findings, issues, and unusual matters that the accountant considered during the performance of the review procedures, including actions taken to address such matters, their disposition, and the final conclusions reached</td>
<td></td>
</tr>
<tr>
<td>g. Communications, whether oral or written, to the appropriate level of management regarding fraud or illegal acts that come to the accountant’s attention</td>
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<tr>
<td>19. Determine that all required forms and checklists have been completed.</td>
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<tr>
<td>20. Determine that all questions, exceptions, or notes, if any, posed during the work have been followed up and resolved, and review notes and “to do” lists have been removed from the working papers.</td>
<td></td>
</tr>
<tr>
<td>21. Date the report as of the date the review was completed.</td>
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</tbody>
</table>
Analytical Procedures the Accountant May Consider Performing When Conducting a Review of Financial Statements

Analytical procedures are designed to identify relationships and individual items that appear to be unusual and that may reflect a material misstatement of the financial statements. The analytical procedures performed in a review of financial statements are a matter of the accountant’s professional judgment. In determining the appropriate analytical procedures, an accountant may consider (a) the nature and materiality of the items reflected in the financial statements, (b) the likelihood of a misstatement in the financial statements, (c) knowledge obtained during current and previous engagements, (d) the stated qualifications of the entity’s accounting personnel, (e) the extent to which a particular item is affected by management’s judgment, and (f) inadequacies in the entity’s underlying financial data.

The following list of analytical procedures is for illustrative purposes only. These analytical procedures will not necessarily be applicable in every review engagement, nor are these analytical procedures meant to be all-inclusive. These illustrative analytical procedures are not intended to serve as a program or checklist to be utilized in performing a review engagement. Examples of analytical procedures an accountant may consider performing in a review of financial statements include the following:

- Comparing financial statements with statements for comparable prior period(s).
- Comparing current financial information with anticipated results, such as budgets or forecasts (for example, comparing tax balances and the relationship between the provision for income taxes and pretax income in the current financial information with corresponding information in (a) budgets, using expected rates, and (b) financial information for prior periods).
- Comparing current financial information with relevant nonfinancial information.
- Comparing ratios and indicators for the current period with expectations based on prior periods, for example, performing gross profit analysis by product line and operating segment using elements of the current financial information and comparing the results with corresponding information for prior periods. Examples of key ratios and indicators are the current ratio, receivables turnover or days’ sales outstanding, inventory turnover, depreciation to average fixed assets, debt to equity, gross profit percentage, net income percentage, and plant operating rates.
- Comparing ratios and indicators for the current period with those of entities in the same industry.
- Comparing relationships among elements in the current financial information with corresponding relationships in the financial information of prior periods, for example, expense by type as a percentage of sales, assets by type as a percentage of total assets, and percentage of change in sales to percentage of change in receivables.

Analytical procedures may include such statistical techniques as trend analysis or regression analysis and may be performed manually or with the use of computer-assisted techniques.

In addition, the accountant may find the guidance in AU section 329, Analytical Procedures (AICPA, Professional Standards, vol. 1), useful in conducting a review of financial statements.

Review of Financial Statements—Illustrative Representation Letter

A review of financial statements consists principally of inquiries of company personnel and analytical procedures applied to financial data. As part of a review of financial statements, the accountant is required to obtain a written representation from his or her client to confirm the oral representations made to the accountant. The introductory paragraph should specify the financial statements and periods covered by the accountant’s review report. If matters exist that should be disclosed to the accountant, they should be indicated by listing them following the representation. The following representation letter is included for illustrative purposes only. The accountant may decide, based on the circumstances

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3 The accountant should exercise caution when comparing and evaluating current financial information with budgets, forecasts, or other anticipated results because of the inherent lack of precision in estimating the future and the susceptibility of such information to manipulation and misstatement by management to reflect desired results.
of the review engagement or the industry in which the entity operates, that other matters should be specifically included in the letter and that some of the representations included in the illustrative letter are not necessary.

(Date \(^4\))

(To the Accountant)

We are providing this letter in connection with your review of the (identification of financial statements) of (name of entity) as of (dates) and for the (periods of review) for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles.

We confirm that we are responsible for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person using the information would be changed or influenced by the omission or misstatement.\(^5\)

We confirm, to the best of our knowledge and belief (as of [the date of the accountant’s review report]), the following representations made to you during your review.

1. The financial statements referred to above are fairly presented in conformity with generally accepted accounting principles.

2. We have made available to you all:
   a. financial records and related data.
   b. minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

3. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.

4. We acknowledge our responsibility to prevent and detect fraud.

5. We have no knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, including any communications received from employees, former employees, or others.

6. We have no plans or intentions that may materially affect the carrying amounts or classification of assets and liabilities.

7. There are no material losses (such as from obsolete inventory or purchase or sales commitments) that have not been properly accrued or disclosed in the financial statements.

8. There are no:
   a. violations or possible violations of laws or regulations, whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
   b. unasserted claims or assessments that our lawyer has advised us are probable of assertion that must be disclosed in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 450, Contingencies.\(^6\)

\(^4\) This date should be the date that the letter is presented and signed by the client. In no event should the letter be presented and signed prior to the date of the accountant’s review report.

\(^5\) The qualitative discussion of materiality used in this letter is adapted from Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information.

\(^6\) If management has not consulted a lawyer regarding litigation, claims, and assessments, the representation might be worded as follows:
c. other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB ASC 450.

9. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets, nor has any asset been pledged as collateral, except as disclosed to you and reported in the financial statements.

10. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

11. The following have been properly recorded or disclosed in the financial statements:
   a. Related party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
   b. Guarantees, whether written or oral, under which the company is contingently liable.
   c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with FASB ASC 275, Risks and Uncertainties. [Significant estimates are estimates at the balance sheet date that could change materially with the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.]
   [Add additional representations that are unique to the entity's business or industry. See below for additional illustrative representations.]

12. We are in agreement with the adjusting journal entry you have recommended, and they have been posted to the company’s account. (if applicable)

13. To the best of our knowledge and belief, no events have occurred subsequent to the balance sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.7

14. We have responded fully and truthfully to all inquiries made to us by you during your review.

(Name of Owner or Chief Executive Officer and Title)

(Name of Chief Financial Officer and Title, where applicable)

Representation letters ordinarily should be tailored to include additional appropriate representations from management relating to matters specific to the entity’s business or industry. The following is a list of additional representations that may be appropriate in certain situations. This list is not intended to be all inclusive. The accountant should consider the effects of pronouncements issued subsequent to the issuance of this section.

<table>
<thead>
<tr>
<th>General</th>
<th>Illustrative Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Condition</td>
<td></td>
</tr>
</tbody>
</table>

We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with FASB Accounting Standards Codification (ASC) 450, Contingencies, and we have not consulted a lawyer concerning litigation, claims, or assessments.

7 If the accountant “dual dates” his or her report, the accountant should consider whether obtaining additional representations relating to the subsequent event is appropriate.
<table>
<thead>
<tr>
<th>The impact of a new accounting principle is not known.</th>
<th>We have not completed the process of evaluating the impact that will result from adopting Financial Accounting Standards Board (FASB) Statement No. [XXX, Name], as discussed in Note [X]. The company is therefore unable to disclose the impact that adopting FASB Statement No. [XXX] will have on its financial position and the results of operations when such statement is adopted.</th>
</tr>
</thead>
<tbody>
<tr>
<td>There is justification for a change in accounting principles.</td>
<td>We believe that [describe the newly adopted accounting principle] is preferable to [describe the former accounting principle] because [describe management's justification for the change in accounting principles].</td>
</tr>
<tr>
<td>Financial circumstances are strained, with disclosure of management’s intentions and the entity’s ability to continue as a going concern.</td>
<td>Note [X] to the financial statements discloses all of the matters of which we are aware that are relevant to the company’s ability to continue as a going concern, including significant conditions and events, and management’s plans.</td>
</tr>
<tr>
<td>The possibility exists that the value of specific significant long lived assets or certain identifiable intangibles may be impaired.</td>
<td>We have reviewed long lived assets and certain identifiable intangibles to be held and used for impairment whenever events or changes in circumstances have indicated that the carrying amount of its assets might not be recoverable and have appropriately recorded the adjustment.</td>
</tr>
<tr>
<td>The entity has a variable interest in another entity.</td>
<td>Variable interest entities (VIEs) and potential VIEs and transactions with VIEs and potential VIEs have been properly recorded and disclosed in the financial statements in accordance with GAAP. We have considered both implicit and explicit variable interests in (a) determining whether potential VIEs should be considered VIEs, (b) calculating expected losses and residual returns, and (c) determining which party, if any, is the primary beneficiary. We have provided you with lists of all identified variable interests in (a) VIEs, (b) potential VIEs that we considered but judged not to be VIEs, and (c) entities that were afforded the scope exceptions of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 810, Consolidation. We have advised you of all transactions with identified VIEs, potential VIEs, or entities afforded the scope exceptions of FASB ASC 810. We have made available all relevant information about financial interests and contractual arrangements with related parties, de facto agents, and other entities, including but not limited to their governing documents, equity and debt instruments, contracts, leases, guarantee arrangements, and other financial contracts and arrangements.</td>
</tr>
</tbody>
</table>

(continued)
The information we provided about financial interests and contractual arrangements with related parties, de facto agents, and other entities includes information about all transactions, unwritten understandings, agreement modifications, and written and oral side agreements.

Our computations of expected losses and expected residual returns of entities that are VIEs and potential VIEs are based on the best information available and include all reasonably possible outcomes.

Regarding entities in which the Company has variable interests (implicit and explicit), we have provided all information about events and changes in circumstances that could potentially cause reconsideration about whether the entities are VIEs or whether the Company is the primary beneficiary or has a significant variable interest in the entity.

We have made and continue to make exhaustive efforts to obtain information about entities in which the Company has an implicit or explicit interest but that were excluded from complete analysis under FASB ASC 810 due to lack of essential information to determine one or more of the following: whether the entity is a VIE, whether the Company is the primary beneficiary, or what accounting is required to consolidate the entity.

The work of a specialist has been used by the entity.

We agree with the findings of specialists in evaluating the [describe assertion] and have adequately considered the qualifications of the specialist in determining the amounts and disclosures used in the financial statements and underlying accounting records. We did not give or cause any instructions to be given to specialists with respect to the values or amounts derived in an attempt to bias their work, and we are not otherwise aware of any matters that have had an impact on the independence or objectivity of the specialists.

### Assets

<table>
<thead>
<tr>
<th>Condition</th>
<th>Illustrative Examples</th>
</tr>
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<tbody>
<tr>
<td>Cash</td>
<td>Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances, line of credit, or similar arrangements.</td>
</tr>
<tr>
<td>Disclosure is required of compensating balances or other arrangements involving restrictions on cash balances, line of credit, or similar arrangements.</td>
<td></td>
</tr>
<tr>
<td>Financial Instruments</td>
<td>Debt securities that have been classified as held-to-maturity have been so classified due to the company’s intent to hold such securities to maturity and the company’s ability to do so. All other debt securities have been classified as available-for-sale or trading.</td>
</tr>
<tr>
<td>Management intends to and has the ability to hold to maturity debt securities classified as held-to-maturity.</td>
<td></td>
</tr>
<tr>
<td>Management considers the decline in value of debt or equity securities to be temporary.</td>
<td>We consider the decline in value of debt or equity securities classified as either available-for-sale or held-to-maturity to be temporary.</td>
</tr>
</tbody>
</table>
Management has determined the fair value of significant financial instruments that do not have readily determinable market values. The methods and significant assumptions used to determine fair values of financial instruments are as follows: [describe methods and significant assumptions used to determine fair values of financial instruments]. The methods and significant assumptions used result in a measure of fair value appropriate for financial statement measurement and disclosure purposes.

There are financial instruments with off-balance-sheet risk and financial instruments with concentrations of credit risk. The following information about financial instruments with off-balance-sheet risk and financial instruments with concentrations of credit risk has been properly disclosed in the financial statements:

1. The extent, nature, and terms of financial instruments with off-balance-sheet risk
2. The amount of credit risk of financial instruments with off-balance-sheet risk and information about the collateral supporting such financial instruments
3. Significant concentrations of credit risk arising from all financial instruments and information about the collateral supporting such financial instruments

Receivables
Receivables have been recorded in the financial statements. Receivables recorded in the financial statements represent valid claims against debtors for sales or other charges arising on or before the balance sheet date and have been appropriately reduced to their estimated net realizable value.

Inventories
Excess or obsolete inventories exist. Provision has been made to reduce excess or obsolete inventories to their estimated net realizable value.

Investments
There are unusual considerations involved in determining the application of equity accounting. [For investments in common stock that are either nonmarketable or of which the entity has a 20 percent or greater ownership interest, select the appropriate representation from the following:]

- The equity method is used to account for the company’s investment in the common stock of [investee] because the company has the ability to exercise significant influence over the investee’s operating and financial policies.
- The cost method is used to account for the company’s investment in the common stock of [investee] because the company does not have the ability to exercise significant influence over the investee’s operating and financial policies.

Deferred Charges
Material expenditures have been deferred. We believe that all material expenditures that have been deferred to future periods will be recoverable.

(continued)
### Deferred Tax Assets

A deferred tax asset exists at the balance sheet date.

The valuation allowance has been determined pursuant to the provisions of FASB ASC 740, *Income Taxes*, including the company’s estimation of future taxable income, if necessary, and is adequate to reduce the total deferred tax asset to an amount that will more likely than not be realized.  *Complete with appropriate wording detailing how the entity determined the valuation allowance against the deferred tax asset.*

or

A valuation allowance against deferred tax assets at the balance sheet date is not considered necessary because it is more likely than not the deferred tax asset will be fully realized.

### Liabilities

<table>
<thead>
<tr>
<th>Condition</th>
<th>Illustrative Examples</th>
</tr>
</thead>
</table>
| **Debt**                                       | The company has excluded short-term obligations totaling $[amount] from current liabilities because it intends to refinance the obligations on a long-term basis.  *Complete with appropriate wording detailing how amounts will be refinanced as follows:*  
  - The Company has issued a long-term obligation [debt security] after the date of the balance sheet but prior to the issuance of the financial statements for the purpose of refinancing the short-term obligations on a long-term basis.  
  - The Company has the ability to consummate the refinancing by using the financing agreement referred to in Note [X] to the financial statements. |
<p>| <strong>Tax-exempt bonds have been issued.</strong>         | Tax-exempt bonds issued have retained their tax-exempt status.                                                                                         |
| <strong>Taxes</strong>                                      | We intend to reinvest the undistributed earnings of [name of foreign subsidiary].                                                                      |
| <strong>Contingencies</strong>                              | Provision has been made for any material loss that is probable from environmental remediation liabilities associated with [name of site]. We believe that such estimate is reasonable based on available information and that the liabilities and related loss contingencies and the expected outcome of uncertainties have been adequately described in the company’s financial statements. |
| <strong>Agreements may exist to repurchase assets previously sold.</strong> | Agreements to repurchase assets previously sold have been properly disclosed.                                                                         |
| <strong>Pension and Postretirement Benefits</strong>       | We believe that the actuarial assumptions and methods used to measure pension liabilities and costs for financial accounting purposes are appropriate in the circumstances. |</p>
<table>
<thead>
<tr>
<th>Condition</th>
<th>Illustrative Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>There is involvement with a multiemployer plan.</td>
<td>We are unable to determine the possibility of a withdrawal liability in a multiemployer benefit plan. or We have determined that there is the possibility of a withdrawal liability in a multiemployer plan in the amount of $[XX].</td>
</tr>
<tr>
<td>Postretirement benefits have been eliminated.</td>
<td>We do not intend to compensate for the elimination of postretirement benefits by granting an increase in pension benefits. or We plan to compensate for the elimination of postretirement benefits by granting an increase in pension benefits in the amount of $[XX].</td>
</tr>
<tr>
<td>Employee layoffs that would otherwise lead to a curtailment of a benefit plan are intended to be temporary.</td>
<td>Current employee layoffs are intended to be temporary.</td>
</tr>
<tr>
<td>Management intends to either continue to make or not make frequent amendments to its pension or other postretirement benefit plans, which may affect the amortization period of prior service cost, or has expressed a substantive commitment to increase benefit obligations.</td>
<td>We plan to continue to make frequent amendments to its pension or other postretirement benefit plans, which may affect the amortization period of prior service cost. or We do not plan to make frequent amendments to its pension or other postretirement benefit plans.</td>
</tr>
</tbody>
</table>

**Equity**

<table>
<thead>
<tr>
<th>Condition</th>
<th>Illustrative Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>There are capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.</td>
<td>Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements have been properly disclosed.</td>
</tr>
</tbody>
</table>

**Income Statement**

<table>
<thead>
<tr>
<th>Condition</th>
<th>Illustrative Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>There may be a loss from sales commitments.</td>
<td>Provisions have been made for losses to be sustained in the fulfillment of or from inability to fulfill any sales commitments.</td>
</tr>
<tr>
<td>There may be losses from purchase commitments.</td>
<td>Provisions have been made for losses to be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of prevailing market prices.</td>
</tr>
<tr>
<td>Nature of the product or industry indicates the possibility of undisclosed sales terms.</td>
<td>We have fully disclosed to you all sales terms, including all rights of return or price adjustments and all warranty provisions.</td>
</tr>
</tbody>
</table>

[Source: appendix F of AR section 100]
.45 Review of Financial Statements—Illustrative Updating Representation Letter

Management need not repeat all of the representations made in the previous representation letter. If matters exist that should be disclosed to the accountant, they should be indicated by listing them following the representation. For example, if an event subsequent to the date of the accountant’s review report is disclosed in the financial statements, the final paragraph could be modified as follows: “To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred...”

[Date]

To [Accountant]

In connection with your review(s) of the identification of financial statements of [name of entity] as of [dates] and for the periods of review for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements for them to be in conformity with generally accepted accounting principles, you were previously provided with a representation letter under date of [date of previous representation letter]. No information has come to our attention that would cause us to believe that any of those previous representations should be modified.

To the best of our knowledge and belief, no events have occurred subsequent to [date of latest balance sheet reported on by the accountant or date of previous representation letter] and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

____________________________________
(Name of Owner or Chief Executive Officer and Title)

____________________________________
(Name of Chief Financial Officer and Title, where applicable)

[Source: appendix G of AR section 100]

.46 Review of Financial Statements—Illustrative Inquiries

The inquiries to be made in a review of financial statements are a matter of the accountant’s professional judgment. In determining the appropriate inquiries, an accountant may consider (a) the nature and materiality of the items reflected in the financial statements, (b) the likelihood of a misstatement in the financial statements, (c) knowledge obtained during current and previous engagements, (d) the stated qualifications of the entity’s accounting personnel, (e) the extent to which a particular item is affected by management’s judgment, and (f) inadequacies in the entity’s underlying financial data. The inquiries should generally be made of members of management with financial reporting and accounting responsibilities.

The following list of inquiries is for illustrative purposes only. These inquiries will not necessarily be applicable in every review engagement, nor are these inquiries meant to be all-inclusive. These illustrative inquiries are not intended to serve as a program or checklist to be utilized in performing a review engagement; rather, they address general areas where inquiries might be made in a review engagement. These sample inquiries can also be found in appendix B of AR section 100. Also, the accountant may feel it necessary to make several inquiries in an effort to answer questions related to the issues addressed in these illustrative inquiries.

1. General
   a. Have there been any changes in the entity’s business activities?
   b. Are there any unusual or complex situations that may have an effect on the financial statements (for example, business combinations, restructuring plans, or litigation)?

---

8 The accountant has two methods available for dating the report when a subsequent event requiring disclosure occurs after the completion of the review but before issuance of the report on the related financial statements. The accountant may use “dual dating,” for example, “February 16, 20XX, except for Note Y, as to which the date is March 1, 20XX,” or may date the report as of the later date.
c. What procedures are in place related to recording, classifying, and summarizing transactions and accumulating information related to financial statement disclosures?

d. Have the financial statements been prepared in conformity with generally accepted accounting principles or, if appropriate, a comprehensive basis of accounting other than generally accepted accounting principles? Have there been any changes in accounting principles and methods of applying those principles? Have voluntary changes in accounting principles been reflected in the financial statements through retrospective application of the new principle in comparative financial statements?

e. Have there been any instances of fraud or illegal acts within the entity?

f. Have there been any allegations or suspicions that fraud or illegal acts might have occurred or might be occurring within the entity? If so, where and how?

g. Are any entities, other than the reporting entity, commonly controlled by the owners? If so, has an evaluation been performed to determine whether those other entities should be consolidated into the financial statements of the reporting entity?

h. Are there any entities other than the reporting entity in which the owners have significant investments (for example, variable interest entities)? If so, has an evaluation been performed to determine whether the reporting entity is the primary beneficiary related to the activities of these other entities?

i. Is the reporting entity a general partner in a limited partnership arrangement? If so, has an evaluation been performed to determine whether the limited partnership should be consolidated into the financial statements of the reporting entity?

j. Is the reporting entity a controlling partner in a general partnership agreement? If so, has an evaluation been performed to determine whether the partnership should be consolidated into the financial statements of the controlling partner?

k. Have any significant transactions occurred or been recognized near the end of the reporting period?

2. Cash and cash equivalents

a. Is the entity’s policy regarding the composition of cash and cash equivalents in accordance with FASB ASC 230-10-45, FASB ASC 230-10-50-1, and FASB ASC glossary terms cash and cash equivalents? Has the policy been applied on a consistent basis? Have there been any changes to withdrawal restrictions related to short term investments that could affect the description and classification of cash equivalents?

b. Are all cash and cash equivalents accounts on a timely basis?

c. Have old or unusual reconciling items between bank balances and book balances been reviewed and adjustments made where necessary?

d. Has there been a proper cutoff of cash receipts and disbursements?

e. Has a reconciliation of intercompany transfers been prepared?

f. Have checks written but not mailed as of the financial statement date been properly reclassified into the liability section of the balance sheet?

g. Have material bank overdrafts been properly reclassified into the liability section of the balance sheet?

---

9 Cash and cash equivalents include all cash and highly liquid investments that are both (a) readily convertible to cash and (b) so near to maturity that they present insignificant risk of changes in value because of changes in interest rates, in accordance with FASB ASC glossary terms cash and cash equivalents.
h. Are there compensating balances or other restrictions on the availability of cash and cash equivalents balances? If so, has consideration been given to reclassifying these amounts as noncurrent assets?

i. Have cash funds been counted and reconciled with control accounts?

3. Receivables

a. Has an adequate allowance for doubtful accounts been properly reflected in the financial statements?

b. Have uncollectible receivables been written off through a charge against the allowance account or earnings? Are there any customer bankruptcy or liquidity issues that would have a material effect on the financial statements?

c. Has interest earned on receivables been properly reflected in the financial statements?

d. Has there been a proper cutoff of sales transactions?

e. Have there been any changes in major contracts with customers that may impact the classification or valuation of receivables?

f. Are there receivables from employees or other related parties? Have receivables from owners been evaluated to determine if they should be reflected in the equity section (rather than the asset section) of the balance sheet?

g. Are any receivables pledged, discounted, or factored? Are recourse provisions properly reflected in the financial statements?

h. Have receivables been properly classified between current and noncurrent?

i. Have there been significant numbers of sales returns or credit memoranda issued subsequent to the balance sheet date?

j. Is the accounts receivable subsidiary ledger reconciled to the general ledger account balance on a regular basis?

4. Inventory

a. Are physical inventory counts performed on a regular basis, including at the end of the reporting period? Are the count procedures adequate to ensure an appropriate count? If not, how have amounts related to inventories been determined for purposes of financial statement presentation? If so, what procedures were used to take the latest physical inventory and what date was that inventory taken?

b. Have general ledger control accounts been adjusted to agree with the physical inventory count? If so, were the adjustments significant?

c. If the physical inventory counts were taken at a date other than the balance sheet date, what procedures were used to determine changes in inventory between the date of the physical inventory counts and the balance sheet date?

d. Were consignments in or out considered in taking physical inventories?

e. What is the basis of valuing inventory for purposes of financial statement presentation?

f. Does inventory cost include material, labor, and overhead where applicable?

g. Has inventory been reviewed for obsolescence or cost in excess of net realizable value? If so, how are these costs reflected in the financial statements?

h. Have proper cutoffs of purchases, goods in transit, and returned goods been made?
i. Are there any inventory encumbrances?

j. Is scrap inventoried and controlled?

k. Have abnormal costs related to inventory been expensed as incurred?

5. Prepaid expenses

a. What is the nature of the amounts included in prepaid expenses?

b. How are these amounts being amortized?

6. Investments

a. What is the basis of accounting for investments reported in the financial statements (for example, securities, joint ventures, or closely held businesses)?

b. Are derivative instruments properly measured and disclosed in the financial statements? If those derivatives are utilized in hedge transactions, have the documentation or assessment requirements related to hedge accounting been met?

c. Are investments in marketable debt and equity securities properly classified as trading, available-for-sale, and held-to-maturity?

d. How were fair values of the reported investments determined? Have unrealized gains and losses been properly reported in the financial statements?

e. If the fair values of marketable debt and equity securities are less than cost, have the declines in value been evaluated to determine whether the declines are other-than-temporary?

f. For any debt securities classified as held-to-maturity, does management have the positive ability and intent to hold the securities until they mature? If so, have those debt securities been properly measured?

g. Have gains and losses related to disposal of investments been properly reflected in the financial statements?

h. How was investment income determined? Is investment income properly reflected in the financial statements?

i. Has appropriate consideration been given to the classification of investments between current and noncurrent?

j. For investments made by the reporting entity, have consolidation, equity, or cost method accounting requirements been considered?

k. Are any investments encumbered?

7. Property and equipment

a. Are property and equipment items properly stated at depreciated cost or other proper value?

b. When was the last time a physical inventory of property and equipment was taken?

c. Are all items reflected in property and equipment held for use? If not, have items that are held for sale been properly reclassified from property and equipment?

d. Have gains or losses on disposal of property or equipment been properly reflected in the financial statements?

e. What are the criteria for capitalization of property and equipment? Have the criteria been consistently and appropriately applied?
f. Are repairs and maintenance costs properly reflected as an expense in the income statement?

g. What depreciation methods and rates are utilized in the financial statements? Are these methods and rates appropriate and applied on a consistent basis?

h. Are there any unrecorded additions, retirements, abandonments, sales, or trade-ins?

i. Does the entity have any material lease agreements? If so, have those agreements been properly evaluated for financial statement presentation purposes?

j. Are there any asset retirement obligations associated with tangible long-lived assets? If so, has the recorded amount of the related asset been increased because of the obligation and is the liability properly reflected in the liability section of the balance sheet?

k. Has the entity constructed any of its property and equipment items? If so, have all components of cost been reflected in measuring these items for purposes of financial statement presentation, including, but not limited to, capitalized interest?

l. Has there been any significant impairment in value of property and equipment items? If so, has any impairment loss been properly reflected in the financial statements?

m. Are any property or equipment items mortgaged or otherwise encumbered? If so, are these mortgages and encumbrances properly reflected in the financial statements?

8. Intangibles and other assets

a. What is the nature of the amounts included in other assets?

b. Do these assets represent costs that will benefit future periods? What is the amortization policy related to these assets? Is this policy appropriate?

c. Have other assets been properly classified between current and noncurrent?

d. Are intangible assets with finite lives being appropriately amortized?

e. Are the costs associated with computer software properly reflected as intangible assets (rather than property and equipment) in the financial statements?

f. Are the costs associated with goodwill (and other intangible assets with indefinite lives) properly reflected as intangible assets in the financial statements? Has amortization ceased related to these assets?

g. Has there been any significant impairment in value of these assets? If so, has any impairment loss been properly reflected in the financial statements?

h. Are any of these assets mortgaged or otherwise encumbered?
f. Are any liabilities collateralized or subordinated? If so, are those liabilities disclosed in the financial statements?

g. Are there any payables to employees or related parties?

10. Long-term liabilities

a. Are the terms and other provisions of long-term liability agreements properly disclosed in the financial statements?

b. Have liabilities been properly classified between current and noncurrent?

c. Has interest expense been properly accrued and reflected in the financial statements?

d. Is the company in compliance with loan covenants and agreements? If not, is the noncompliance properly disclosed in the financial statements?

e. Are any long-term liabilities collateralized or subordinated? If so, are these facts disclosed in the financial statements?

f. Are there any obligations that, by their terms, are due on demand within one year from the balance sheet date? If so, have these obligations been properly reclassified into the current liability section of the balance sheet?

11. Income and other taxes

a. Do the financial statements reflect an appropriate provision for current and prior-year income taxes payable?

b. Have any assessments or reassessments been received? Are there tax authority examinations in process?

c. Are there any temporary differences between book and tax amounts? If so, have deferred taxes on these differences been properly reflected in the financial statements?

d. Do the financial statements reflect an appropriate provision for taxes other than income taxes (for example, franchise, sales)?

e. Have all required tax payments been made on a timely basis?

f. Has the entity assessed uncertain tax positions and related disclosures in accordance with FASB ASC 740, *Income Taxes*?

12. Other liabilities, contingencies, and commitments

a. What is the nature of the amounts included in other liabilities?

b. Have other liabilities been properly classified between current and noncurrent?

c. Are there any guarantees, whether written or verbal, whereby the entity must stand ready to perform or is contingently liable related to the guarantee? If so, are these guarantees properly reflected in the financial statements?

d. Are there any contingent liabilities (for example, discounted notes, drafts, endorsements, warranties, litigation, and unsettled asserted claims)? Are there any potential unasserted claims? Are these contingent liabilities, claims, and assessments properly measured and disclosed in the financial statements?

e. Are there any material, contractual obligations for construction or purchase of property and equipment or any commitments or options to purchase or sell company securities? If so, are these facts clearly disclosed in the financial statements?
f. Is the entity responsible for any environmental remediation liability? If so, is this liability properly measured and disclosed in the financial statements?

g. Does the entity have any agreement to repurchase items that previously were sold? If so, have the repurchase agreements been taken into account in determining the appropriate measurements and disclosures in the financial statements?

h. Does the entity have any sales commitments at prices expected to result in a loss at the consummation of the sale? If so, are these commitments properly reflected in the financial statements?

i. Are there any violations, or possible violations, of laws or regulations the effects of which should be considered for financial statement accrual or disclosure?

13. Equity

a. What is the nature of any changes in equity accounts during each reporting period?

b. What classes of stock (other ownership interests) have been authorized?

c. What is the par or stated value of the various classes of stock (other ownership interests)?

d. Do amounts of outstanding shares of stock (other ownership interests) agree with subsidiary records?

e. Have pertinent rights and privileges of ownership interests been properly disclosed in the financial statements?

f. Does the entity have any mandatorily redeemable ownership interests? If so, have these ownership interests been evaluated so that a proper determination has been made related to whether these ownership interests should be measured and reclassified to the liability section of the balance sheet? Are redemption features associated with ownership interests clearly disclosed in the financial statements?

g. Have dividend (distribution) and liquidation preferences related to ownership interests been properly disclosed in the financial statements?

h. Do disclosures related to ownership interests include any applicable call provisions (prices and dates), conversion provisions (prices and rates), unusual voting rights, significant terms of contracts to issue additional ownership interests, or any other unusual features associated with the ownership interests?

i. Are syndication fees properly reflected in the financial statements as a reduction of equity (rather than an asset)?

j. Have any stock options or other stock compensation awards been granted to employees or others? If so, are these options or awards properly measured and disclosed in the financial statements?

k. Has the entity made any acquisitions of its own stock? If so, are the amounts associated with these reacquired shares properly reflected in the financial statements as a reduction in equity? Is the presentation in accordance with applicable state laws?

l. Are there any restrictions or appropriations on retained earnings or other capital accounts? If so, are these restrictions or appropriations properly reflected in the financial statements?

14. Revenue and expenses

a. What is the entity’s revenue recognition policy? Is the policy appropriate? Has the policy been consistently applied and appropriately disclosed?
b. Are revenues from sales of products and rendering of services recognized in the appropriate reporting period (that is, when the products have been delivered and when the services have been performed)?

c. Were any sales recorded under a “bill and hold” arrangement? If yes, have the criteria been met to record the transaction as a sale?

d. Are purchases and expenses recognized in the appropriate reporting period (that is, matched against revenue) and properly classified in the financial statements?

e. Do the financial statements include discontinued operations or items that might be considered extraordinary, or both? If so, are amounts associated with discontinued operations, extraordinary items, or both properly displayed in the income statement?

f. Does the entity have any gains or losses that would necessitate the display of comprehensive income (for example, gains or losses on available-for-sale securities or cash flow hedge derivatives)? If so, have these items been properly displayed within comprehensive income (rather than included in the determination of net income)?

15. Other

a. Have events occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements?

b. Has the entity considered whether declines in market values subsequent to the balance sheet date may be permanent or caused the entity to no longer be in compliance with its loan covenants?

c. Have actions taken at stockholders, directors, committees of directors, or comparable meetings that affect the financial statements been reflected in the financial statements?

d. Are significant estimates and material concentrations (for example, customers or suppliers) properly disclosed in the financial statements?

e. Are there plans or intentions that may materially affect the carrying amounts or classification of assets and liabilities reflected in the financial statements?

f. Have there been material transactions between or among related parties (for example, sales, purchases, loans, or leasing arrangements)? If so, are these transactions properly disclosed in the financial statements?

g. Are there uncertainties that could have a material impact on the financial statements? Is there any change in the status of previously disclosed material uncertainties? Are all uncertainties, including going concern matters, that could have a material impact on the financial statements, properly disclosed in the financial statements?

h. Are barter or other nonmonetary transactions properly recorded and disclosed? Have nonmonetary asset exchanges involving commercial substance been reflected in the financial statements at fair value? Have nonmonetary asset exchanges not involving commercial substance been reflected in the financial statements at carrying value?

[Source: appendix B of AR section 100]
### Illustrative Ratio Analysis Worksheet

In the following table, you will find 24 financial ratios. These financial ratios include liquidity, activity, and efficiency ratios. The table is for illustrative purposes only. The ratios will not necessarily be applicable in every review engagement, nor are they meant to be all-inclusive.

<table>
<thead>
<tr>
<th>Ratio Name</th>
<th>Formula</th>
<th>Calculation</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current ratio</td>
<td>Current Assets</td>
<td>Calculation</td>
<td>Measures ability to meet short term obligations</td>
</tr>
<tr>
<td></td>
<td>Current Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quick ratio (or acid test ratio)</td>
<td>Current Assets - Inventory</td>
<td>Current Liabilities</td>
<td>A more conservative measure of a firm’s ability to meet short term obligations</td>
</tr>
<tr>
<td></td>
<td>Current Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating cash flows to current liabilities</td>
<td>Cash Provided by Operations</td>
<td>Average Current Liabilities</td>
<td>Liquidity calculation</td>
</tr>
<tr>
<td>Days sales in accounts receivable</td>
<td>Net Accounts Receivable</td>
<td>Net Sales/360</td>
<td>Measures length of time average sales is a receivable</td>
</tr>
<tr>
<td>Allowance for bad debts as a % of accounts receivable</td>
<td>Allowance for Bad Debts Accounts Receivable</td>
<td></td>
<td>Calculation is compared to prior periods and other comparable companies</td>
</tr>
<tr>
<td>Bad debt expense as a % of net sales</td>
<td>Bad Debt Expense</td>
<td>Net Sales</td>
<td>Calculation is compared to prior periods and other comparable companies</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory turnover</td>
<td>Cost of Sales</td>
<td>Inventory</td>
<td>Activity ratio - indication of efficiency of operation</td>
</tr>
<tr>
<td>Fixed asset turnover</td>
<td>Net Sales</td>
<td>Average Fixed Assets</td>
<td>Activity ratio</td>
</tr>
<tr>
<td>Receivable turnover</td>
<td>Net Credit Sales</td>
<td>Average Receivables</td>
<td>Activity ratio</td>
</tr>
<tr>
<td>Net sales to inventory</td>
<td>Net Sales</td>
<td>Inventory</td>
<td>Activity ratio</td>
</tr>
<tr>
<td>Days in inventory</td>
<td>Inventory × (Days in a cycle)</td>
<td>Cost of Sales</td>
<td>Identifies how many days of inventory is available</td>
</tr>
<tr>
<td>Accounts payable to net sales</td>
<td>Accounts Payable × (Days in a cycle)/Net Sales × (Days in a year)</td>
<td></td>
<td>Compares A/P balance to net sales</td>
</tr>
<tr>
<td>Return on total assets</td>
<td>Net Income × (Days in a year)/Total Assets × (Days in a cycle)</td>
<td></td>
<td>Measures profitability at a point in time</td>
</tr>
<tr>
<td>Return on net worth</td>
<td>Net Income × (Days in a year)/Net Worth × (Days in a cycle)</td>
<td></td>
<td>Profitability measure</td>
</tr>
<tr>
<td>Return on net sales</td>
<td>Net Income</td>
<td>Net Sales</td>
<td>Profit margin</td>
</tr>
<tr>
<td>Ratio Name</td>
<td>Formula</td>
<td>Calculation</td>
<td>Explanation</td>
</tr>
<tr>
<td>----------------------------------------</td>
<td>----------------------------------------------</td>
<td>---------------------------------------</td>
<td>-----------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Net sales to accounts receivable</td>
<td>(\text{Net Sales} \times \text{Days in a year}) (\text{Net A/R} \times \text{Days in a cycle})</td>
<td>Identifies how many times A/R will turn over per year of the operating cycle</td>
<td></td>
</tr>
<tr>
<td>Net sales to net fixed assets</td>
<td>(\text{Net Sales} \times \text{Days in a year}) (\text{Fixed Assets} \times \text{Days in a cycle})</td>
<td>Identifies efficiency of capital investment</td>
<td></td>
</tr>
<tr>
<td>Days payables in cost of sales</td>
<td>(\frac{\text{A/P} \times \text{Days in a cycle}}{\text{Cost of Sales}})</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income before tax to net worth</td>
<td>(\frac{\text{EBIT} \times \text{Days in a year}}{\text{Net Worth} \times \text{Days in a cycle}})</td>
<td>Ratio of earnings to net worth per year</td>
<td></td>
</tr>
<tr>
<td>Gross profit percentage</td>
<td>(\frac{\text{Net Sales} - \text{Cost of Sales}}{\text{Net Sales}})</td>
<td>Profitability calculation</td>
<td></td>
</tr>
<tr>
<td>Operating expenses as a % of net sales</td>
<td>(\frac{\text{Operating Expenses}}{\text{Net Sales}})</td>
<td>Efficiency calculation</td>
<td></td>
</tr>
<tr>
<td>Times interest earned</td>
<td>(\frac{\text{EBIT}}{\text{Interest Expense}})</td>
<td>Profitability calculation</td>
<td></td>
</tr>
<tr>
<td>Income before tax to assets</td>
<td>(\frac{\text{EBIT} \times \text{Days in a year}}{\text{Assets} \times \text{Days in a cycle}})</td>
<td>Measure of profitability</td>
<td></td>
</tr>
<tr>
<td>Altman Z score</td>
<td>See Below</td>
<td>A composite formula that is widely used to measure the financial “health” of a company. The formula takes financial ratios and multiplies each by a specific constant. The amounts computed are added together to obtain an overall score. This score is then compared to scores from other companies to rate relative financial health.</td>
<td></td>
</tr>
</tbody>
</table>

For private companies (four variable):

\[
\begin{align*}
\text{Working Capital} & \times 6.56 = \\
\text{Total Assets} & \times 3.26 = \\
\text{Retained Earnings} & \times 6.72 = \\
\text{Income before Interest and Taxes} & \times 6.72 = \\
\text{Total Assets} & \times 1.05 = \\
\text{Net Worth} & \times \\
\text{Total Liabilities} & \\
\text{Altman Z Score} & 
\end{align*}
\]

For private companies (five variable):

AICPA Audit and Accounting Manual
Working Capital \times .717 =
Retained Earnings \times .847 =
Income before Interest and Taxes \times 3.107 =
Net Worth (Book Value) \times .420 =
Total Liabilities \times .998 =
Sales
Total Assets

Altman Z Score

### Illustrative Analytical Procedures Comparative Report

**Sample Services, Inc.**  
*Analytical Procedures Comparative Report*  
For the period ended December 31, 20XX

<table>
<thead>
<tr>
<th>Account Name</th>
<th>Account #</th>
<th>Prior</th>
<th>Ending</th>
<th>Net Change</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash—Operating</td>
<td>110</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash—Savings</td>
<td>115</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Petty cash</td>
<td>118</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>120</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td>130</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prepaid dues</td>
<td>131</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prepaid interest</td>
<td>132</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Supplies inventory</td>
<td>140</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>200</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Buildings</td>
<td>210</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accum. depr.—Buildings</td>
<td>215</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>220</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accum. depr.—Equipment</td>
<td>225</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other assets</td>
<td>250</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Notes payable</td>
<td>310</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>330</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>340</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term debt</td>
<td>390</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td>400</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Paid-in capital</td>
<td>410</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>450</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>510</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>520</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other revenue</td>
<td>530</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Automobile</td>
<td>700</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bad debts</td>
<td>705</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>710</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Donations</td>
<td>715</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>720</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>725</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Licenses &amp; Dues</td>
<td>730</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medical insurance</td>
<td>735</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>740</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Postage</td>
<td>745</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Professional fees</td>
<td>750</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit sharing</td>
<td>755</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Repairs &amp; Maintenance</td>
<td>760</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries—Employees</td>
<td>765</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries—Officers</td>
<td>767</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Supplies</td>
<td>770</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Telephone</td>
<td>775</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Travel</td>
<td>780</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Utilities</td>
<td>785</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>790</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Net Balance</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

[The next page is 2501.]
AAM Section 2500

Form and Content of Financial Statements

.01 Preparing financial statements is both an art and a science, normally learned by trial and error or by word of mouth. The process is an art in that financial statements are typically presented in a format that has eye appeal, is understandable, conveys the company’s financial picture, and can be produced economically. Preparing financial statements is a science in that a mastery of a complex array of authoritative standards for measurement, presentation, and disclosure is needed.

Title Page

.02 A title page is recommended for all financial statement presentations. The title page typically contains the name of the entity, the title of the financial statements, and the date or period covered.

Name of the Entity

.03 The name of the entity is ordinarily presented exactly as it is listed in the charter, partnership agreement, or other appropriate legal document. When the entity is not a regular corporation, the type of entity may be disclosed. Examples of appropriate presentations are as follows:

- Corporation
- XYZ, Ltd.
- Jones Nursery
- The Estate of John Doe
- Mr. and Mrs. John Q. Public
- Jane Doe Testamentary Trust

Title of Financial Statements

.04 If the presentation includes more than one type of financial statement (for example, Balance Sheet and Income Statement), the term financial statements is the most practical method of communicating what is included in the presentation. When only one type of statement is presented, it is more appropriate to use the exact title of the statement. When consolidated or combined statements are presented, the title page includes the words consolidated or combined. When financial statements include supplementary information, the title is modified. Some accountants add a description of the service performed to the title of the financial statements on the title page.

Date or Period Covered

.05 When both a balance sheet and income statement are presented, the period covered by the statement is typically shown, with the period ending date. When only a balance sheet is presented, the date is the balance sheet date, alone.

* In February 2009, the Accounting and Review Services Committee issued Statement on Standards for Accounting and Review Services (SSARS) No. 18, Applicability of Statements on Standards for Accounting and Review Services (AICPA, Professional Standards, vol. 2), which amends paragraph .01 of AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2). SSARS No. 18 revises the applicability of the SSARSs so that SSARSs do not apply when the provisions of AU section 722, Interim Financial Information (AICPA, Professional Standards, vol. 1), apply. SSARS No. 18 is effective for compilations and reviews of financial statements for periods beginning after December 15, 2009, with early application permitted. This manual will be updated for SSARS No. 18 in the next edition.
Presentation of the Accountant’s Report

.06 This section discusses presentation and format of the accountant’s report. Section 2600 discusses the wording of the report and other considerations that affect the degree of responsibility assumed by the accountant.

Letterhead

.07 There is no requirement that the accountant’s report be printed on the firm’s letterhead (nor is there any requirement that the report be manually signed—for example, the signature could be manual, stamped, electronic, or typed—or that the financial statements be bound).

Heading of the Accountant’s Report

.08 No heading is needed for an accountant’s report, although some accountants prefer to use one. This avoids any misunderstanding about the type of report. Examples of appropriate report headings would be as follows:

- Accountant’s Report
- Accountant’s Report on Financial Statements
- Accountant’s Report on Supplementary Information

Address

.09 Generally, the accountant’s report is addressed to the board of directors, stockholders, or both. Reports are not intended as letters. Accordingly, addresses that include street names or zip codes are not appropriate. Examples of appropriate addresses are as follows:

- To the Board of Directors; XYZ Corporation; Greenville, SC
- To the Stockholders; XYZ Corporation
- To the Board of Directors and Shareholders; XYZ Corporation; Greenville, SC
- For small, closely held companies: Mr. John Doe; Small Manufacturing, Inc; Greenville, SC
- For personal financial statements: Mr. And Mrs. John Doe; Greenville, SC
- For partnerships: To the Managing Partner; ABC Company; Greenville, SC or Mrs. Jane Doe; General Partner, XYZ Ltd. Partnership
- For proprietorship: Mr. John Jones; Jones Transportation; Columbia, SC
- For trusts: Mr. John Smith; Trustee; Jane Doe Testamentary Trust; Myrtle Beach, SC
- For estates: Mr. John Doe; Executor; Estate of John Smith; Hilton Head Island, SC

Salutations

.10 Common practice in the profession is to exclude such salutations as “Dear Sirs” or “Gentlemen” from the report.

Signature

.11 The compilation or review report should contain a signature of the accounting firm or the accountant as appropriate. (For example, the signature could be manual, stamped, electronic, or typed.) Some state boards and certain regulatory agencies require an individual’s signature on the report.
Date of Report

.12 The dating of the report affects the responsibility assumed by the accountant and is discussed in more detail in section 2600. The format of the date is rather straightforward. Firms with multiple offices often precede the date of the report with the office’s location.

Basic Financial Statements

.13 The basic financial statements included in a generally accepted accounting principles (GAAP) financial statement presentation are as follows (basic financial statements for an other comprehensive basis of accounting [OCBOA] presentation are discussed in section 2700):

- Balance sheet
- Income statement
- Statement of retained earnings or Changes in stockholders’ equity
- Statement of cash flows

Heading

.14 The heading of each financial statement typically contains the name of the entity, the title of specific statement, and the date or period covered.

Reference on Financial Statements

.15 The following examples demonstrate how the type of reference or legend on the financial statements depends upon the type of engagement:

- If the financial statements are reviewed, each page of the financial statements should contain a reference, such as: See Accountant’s Review Report.

- If the financial statements are compiled for general-use (that is, not restricted), each page of the financial statements should contain a reference, such as: See Accountant’s Compilation Report.

- If the financial statements are not intended to be used by a third party, each page of the financial statements should contain a reference to the restricted nature of the financial statements, such as the following:
  - Restricted for Management’s Use Only, or
  - Solely for the information of and use by the management of XYZ Company and not intended to be and should not be used by any other party.

- If the financial statements are compiled and included in certain prescribed forms (according to AR section 300, Compilation Reports on Financial Statements Included in Certain Prescribed Forms [AICPA, Professional Standards, vol. 2]), each page of the form should include a reference, such as: See Accountant’s Compilation Report.

- If the financial statements are personal financial statements prepared for inclusion in a personal financial plan (AR section 600, Reporting on Personal Financial Statements Included in Written Personal Financial Plans [AICPA, Professional Standards, vol. 2]), each of the personal financial statements should contain a reference to the report, such as: See Accountant’s Report.

.16 Note that, in all cases, these requirements extend to the notes (because the notes are part of the financial statements). However, there is diversity in practice as to how to meet this requirement for notes. Some accountants place the reference on each page of the notes, and others place the reference only on the first page.

---

1 The accounting literature does not require the statement of retained earnings and the statement of comprehensive income to be presented. If the statement of retained earnings and the statement of comprehensive income are not presented, then the information in those statements must be presented in other financial statements.
of the notes. Still others place a statement on each page of the financial statements that “the notes are an integral part of the financial statements” and, therefore, do not place the reference on the note pages. Any of these approaches is acceptable.

.17 Also, the previous references are examples given in Statements on Standards for Accounting and Review Services (SSARSs), and the accountant may modify the wording of the reference. AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2), states that the accountant refer to the report—not that he or she state the type of report (level of service) in the reference. Therefore, the reference “See Accountant’s Report” would be sufficient in all engagements that contain a report. However, most accountants follow the wording given in the examples. Accountants may place the reference on the financial statements by installing footers in the financial statement software, by using a rubber stamp, by manually writing the reference, or by any other method that is practical to use.

Use of the Term Unaudited

.18 Some accountants follow the financial statement title with the term unaudited. This practice is not required by SSARSs and may be misleading.

Supplementary Information

.19 Financial statements of nonpublic companies often include detailed schedules, summaries, comparisons, or statistical information that are not part of the basic financial statements, such as the following:

- Budgets for an expired period
- Cost of goods sold schedule
- Manufacturing expenses schedule
- Selling expenses
- General and administrative expenses
- Details of marketable securities
- Property and equipment schedule
- Aging analysis of accounts receivable
- Details of sales by product line, territory, or salesman

Presentation

.20 Normally, supplementary information is segregated from the basic financial statements, after a title page marked “Supplementary Information.” If a separate report on the supplementary information is presented, it typically follows the title page.

Reporting

.21 The accountant should describe in the report on the financial statements, or in a separate report, the degree of responsibility, if any, he or she takes with regard to the supplementary information. See section 2600 for information on suggested wording for compilation and review reports.

Headings

.22 Each schedule is typically headed with a descriptive title that distinguishes it from the basic financial statements. Normally, supplementary schedules are not referred to as statements to avoid confusing them with basic financial statements.
Reference to Report

.23 Each supplementary schedule may contain a reference to the report. Although not specifically addressed in SSARSs, the reference is advisable because the report describes the degree of responsibility the accountant takes with regard to the schedules.

Disclosures

.24 In general, all financial statements should include adequate disclosures (notes). However, there are situations in which the financial statements may not include one or more disclosures. Depending upon the situation, the compilation report may have to be modified.

.25 If all disclosures are omitted, then add an extra paragraph to the compilation report, as follows:

Management has elected to omit substantially all of the disclosures (and the statement of comprehensive income and the statement of cash flows) required by generally accepted accounting principles. If the omitted disclosures and statements were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

.26 Note that if the financial statements are presented in accordance with an OCBOA (for example, income tax basis), this extra paragraph would be worded as follows:

Management has elected to omit substantially all of the disclosures ordinarily included in financial statements prepared on the income tax basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the company’s assets, liabilities, equity, revenues, and expenses. Accordingly, these financial statements are not designed for those who are not informed about such matters.

.27 This additional paragraph is appropriate if all, or substantially all, disclosures are omitted. The additional paragraph is not appropriate if substantially all disclosures are included (most, but not all disclosures). If selected disclosures are included they typically are not labeled as “Notes to the Financial Statements” (this title implies full disclosure). Instead, an appropriate title would be “Selected Information—Substantially All Disclosures Required by GAAP Are Not Included.”

Referencing Notes

.28 Although there is no requirement that individual notes be referenced to specific items in the financial statements, each page of the financial statements generally contains a general reference to the notes. If selected information rather than all notes is presented in a compilation, a reference to the selected information is ordinarily included.

[The next page is 2551.]
AAM Section 2600

Reporting *

Reporting Obligation

.01 AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2) discusses the accountant’s reporting obligation for compilation and review engagements. In summary, it says the following:

- A compilation is the minimum level of service that an accountant can provide if the accountant submits unaudited financial statements of a nonissuer to a client or others (paragraph .01 of AR section 100)
- The accountant should not consent to the use of his or her name in a document or written communication containing unaudited financial statements of a nonissuer unless (a) the accountant has compiled or reviewed the financial statements in compliance with the provisions of AR section 100, or (b) the financial statements are accompanied by an indication that the accountant has not compiled or reviewed the financial statements, and that the accountant assumes no responsibility for them. For example, according to paragraph .03 of AR section 100, the indication may be worded as follows:

  *The accompanying balance sheet of X Company as of December 31, 20X1, the related statements of income, and cash flows for the year then ended were not audited, reviewed, or compiled by us and, accordingly, we do not express an opinion or any other form of assurance on them.*

- The accountant should issue a report prepared in accordance with Statements on Standards for Accounting and Review Services (SSARSs) whenever he or she is engaged to compile financial statements of a nonissuer, or submits financial statements that are reasonably expected to be used by a third party (paragraph .13 of AR section 100)
- The accountant should issue a report prepared in accordance with SSARSs whenever he or she is engaged to review financial statements of a nonissuer (paragraph .46 of AR section 100)

.02 The first item in the bulleted list above is addressed in paragraph .01 of AR section 100. Whenever the accountant prepares financial statements (manually or using a computer) and presents them to a client or third parties, he or she has submitted financial statements.

.03 The second item in the bulleted list in paragraph .01 of this section of the manual is aimed at situations when a client includes the accountant’s name in a loan proposal, prospectus, or other written communication that includes client prepared financial statements.

.04 The third and fourth items addressed in the bulleted list in paragraph .01 of this section of the manual are discussed in more detail in the following sections.

*In February 2009, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 18, Applicability of Statements on Standards for Accounting and Review Services (AICPA, Professional Standards, vol. 2), which amends paragraph .01 of AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2). SSARS No. 18 revises the applicability of the SSARSs so that SSARSs do not apply when the provisions of AU section 722, Interim Financial Information (AICPA, Professional Standards, vol. 1), apply. SSARS No. 18 is effective for compilations and reviews of financial statements for periods beginning after December 15, 2009, with early application permitted. This manual will be updated for SSARS No. 18 in the next edition.*

AICPA Audit and Accounting Manual

AAM §2600.04
Basic Compilation Reports

.05 The basic elements of a report on compiled financial statements are as follows:

- A statement that a compilation has been performed in accordance with SSARSs, issued by the AICPA
- A statement that a compilation is limited to presenting in the form of financial statements information that is the representation of management (owners)
- A statement that the financial statements have not been audited or reviewed and, accordingly, the accountant does not express an opinion or any other form of assurance on them
- A signature of the accounting firm or the accountant as appropriate (For example, the signature could be manual, stamped, electronic, or typed.)
- The date of the compilation report (The date of completion of the compilation should be used as the date of the accountant’s report.)

.06 The report should not refer to any other procedures that the accountant may have performed before or during the compilation engagement. To do so might lead the reader to conclude that the accountant is, in fact, offering some form of assurance.

Basic Review Reports

.07 The basic elements of a report on financial statements reviewed by an accountant are as follows:

- A statement that a review has been performed in accordance with SSARS, issued by the AICPA
- A statement that all information included in the financial statements is the representation of management (owners) of the entity
- A statement that a review consists principally of inquiries of company personnel and analytical procedures applied to financial data
- A statement that a review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements taken as a whole and, accordingly, no such opinion is expressed
- A statement that the accountant is not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework (for example, generally accepted accounting principles [GAAP]), other than those modifications, if any, indicated in the report
- A signature of the accounting firm or the accountant as appropriate (For example, the signature could be manual, stamped, electronic, or typed.)
- The date of the review report (The date of the completion of the accountant’s review procedures should be used as the date of the accountant’s report.)

.08 Any other procedures that the accountant may have performed before or during the review engagement, including those performed in connection with a compilation of the financial statements, should not be described in the report.

Reporting When Not Independent

.09 An accountant is precluded from issuing a review report on the financial statements of an entity with respect to which he is not independent. He or she may, however, issue a compilation report.

---

1 In making a judgment about whether he or she is independent, the accountant should be guided by the AICPA Code of Professional Conduct.

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The compilation report should specifically disclose the lack of independence. However, the reason for lack of independence should not be described. When the accountant is not independent, he or she should include the following as the last paragraph of the compilation report:

I am (we are) not independent with respect to XYZ Company.

Reporting on Financial Statements That Omit Disclosures

In general, financial statements should include adequate disclosures (notes). However, there are situations in which management may elect to omit one or more disclosures. Depending upon the situation, the compilation report may have to be modified.

If all disclosures are omitted, then add an extra paragraph to the compilation report, as follows:

Management has elected to omit substantially all of the disclosures (and the statement of comprehensive income and the statement of cash flows) required by generally accepted accounting principles. If the omitted disclosures and statements were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

Note that if the financial statements are presented on a basis of accounting other than GAAP (for example, income tax basis), this extra paragraph would be worded as follows:

Management has elected to omit substantially all of the disclosures ordinarily included in financial statements prepared on the income tax basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the company’s assets, liabilities, equity, revenue, and expenses. Accordingly, these financial statements are not designed for those who are not informed about such matters.

This additional paragraph is appropriate if all, or substantially all, disclosures are omitted. The additional paragraph is not appropriate if substantially all disclosures are included (most, but not all disclosures). If selected disclosures are included they typically are not labeled as “Notes to the Financial Statements” (this title implies full disclosure). Instead, an appropriate title would be “Selected Information—Substantially All Disclosures Required by GAAP Are Not Included.”

Interpretation No. 1, “Omission of Disclosures in Reviewed Financial Statements,” of AR section 100 (AICPA, Professional Standards, vol. 2, AR sec. 9100 par. 01–02) indicates that the previously mentioned modification for compiled financial statements is not appropriate for reviewed financial statements. Because the omission of substantially all disclosures is a departure from GAAP, the review report should include the omitted disclosures.

When the financial statements include substantially all disclosures, the guidance above is not appropriate. Rather, the omission of a single disclosure or a few disclosures should be treated in a compilation or review report like any other departure from GAAP, and the accountant should disclose the nature of the departure and its effects, if known.

Reporting on Financial Statements With Departures From GAAP

Although compiled financial statements may omit substantially all disclosures required by GAAP, the omission of disclosures that are material to reviewed financial statements is a GAAP departure that should be disclosed in the accountant’s review report. As discussed previously, the accountant should include in the review report all of the omitted disclosures or, if the details to be disclosed have not been determined, the specific nature of the omitted disclosures. If, in the course of a compilation or review engagement, the accountant becomes aware of departures from GAAP that are material to the financial statements, he or she has the following three alternatives:
• Persuade the client to revise the financial statements to conform to GAAP
• Refer to the departure in the report
• Withdraw from the engagement

.18 If modification of the report is appropriate, the nature of the departure from GAAP should be disclosed in a separate paragraph, and the effects (that is, the dollar amount) of the departure should be disclosed, if known. If the effects are not known, the accountant is not required to determine them, provided the accountant states in his report that no determination of the effects of the departure has been made.

Reporting When There Are Significant Departures From GAAP

.19 According to Interpretation No. 7, “Reporting When There Are Significant Departures From GAAP,” of AR section 100 (AICPA, Professional Standards, vol. 2, AR sec. 9100 par. .23–.26) an accountant cannot modify a compilation or review report to indicate that the financial statements are not fairly presented in accordance with GAAP. Thus, an adverse opinion is not appropriate in a compilation or review engagement.

.20 Interpretation No. 7 of AR section 100 indicates that the accountant may wish to emphasize the limitations of financial statements having significant GAAP departures in a separate paragraph in the report. This paragraph is in addition to the one that describes the departure. Suggested wording for such a paragraph follows:

Because the significance and pervasiveness of the matters discussed above make it difficult to assess their impact on the financial statements taken as a whole, users of these financial statements should recognize that they might reach different conclusions about the company’s financial position, results of operations, and cash flows if they had access to revised financial statements prepared in conformity with generally accepted accounting principles.

Date of Reports

.21 The date of the completion of the accountant’s review procedures should be used as the date of his or her report on reviewed financial statements. The date of completion of the compilation should be used as the date of his or her report on compiled financial statements.

Highest Level of Service

.22 If the accountant provides more than one level of service on the same financial statements (for example, compilation and review or review and audit), the financial statements should be accompanied by a report that is appropriate for the highest level of service provided. This does not preclude the accountant from using procedures that go beyond those required for the level of service.

.23 Interpretation No. 3, “Reporting on the Highest Level of Service,” of AR section 100 (AICPA, Professional Standards, vol. 2, AR sec. 9100 par. .06–.12) provides guidance on the type of report to be issued when the accountant performs procedures that go beyond those required. It states that simply performing procedures (for example, analytical procedures in a compilation engagement) do not require the issuance of the higher report.

.24 Interpretation No. 13, “Additional Procedures,” of AR section 100 (AICPA, Professional Standards, vol. 2, AR sec. 9100 par. .46–.49) addresses whether an accountant can perform audit procedures in a compilation or review engagement and still issue a compilation or review report. It states that SSARSs do not preclude the accountant from performing procedures that he deems necessary or that his client requests.

.25 Both interpretations stress the importance of the understanding with the client.
.26 An exception to the highest level of service rule is indicated in paragraph .53 of AR section 100. If the accountant is engaged to perform an audit or a review, but finds that he or she is not independent, the auditor may issue a compilation report provided that he or she complies with the compilation standards.

.27 AR section 300, Compilation Reports on Financial Statements Included in Certain Prescribed Forms (AICPA, Professional Standards, vol. 2), permits another exception to the highest level of service rule. It allows an accountant who has reviewed financial statements to issue a compilation report on financial statements for the same period included in a prescribed form.

Performing a Lower Level of Service

.28 Accountants may be asked to perform a lower level of service from the one they previously performed on financial statements covering the same period, depending on the situation. Examples are as follows:

- The client requests the accountant to compile financial statements that omit substantially all disclosures, even though the accountant has already compiled, reviewed, or audited full disclosure financial statements for the same period.
- The client requests the accountant to compile a balance sheet that omits substantially all disclosures, even though the accountant has already compiled, reviewed, or audited the complete financial statements for the same period.

.29 Because professional standards are silent on this issue, practice varies. Many accountants will consent to providing the compilation as long as they are satisfied that the client has a valid business reason for the request and is not attempting to mislead anyone. However, questions frequently arise about the form of the report. The most common question is whether the report should refer to the prior level of service performed on the statements. Again, the professional standards are silent.

Reporting When the Statement of Cash Flows or Comprehensive Income Information Is Omitted, or Both

.30 Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 230, Statement of Cash Flows, requires that a statement of cash flows be presented for each period for which an income statement is presented. Thus, omitting the statement of cash flows constitutes a departure from GAAP. Like other departures from GAAP, the accountant should disclose the departure in a separate paragraph of his report. An example wording of the separate paragraph follows:

A statement of cash flows for the year ended December 31, 20XX, has not been presented. Generally accepted accounting principles require that such a statement be presented when the financial statements purport to present financial position and results of operations.

.31 According to FASB ASC 220, Comprehensive Income, all business entities that have any component of comprehensive income must display information about comprehensive income in a financial statement having the same prominence as the other basic financial statements. The primary components of other comprehensive income include the following:

- Unrealized gains and losses arising from investments in marketable securities classified as “available for sale” (FASB ASC 320, Investments—Debt and Equity Securities)
- Foreign currency translation adjustments and gains and losses from certain foreign currency transactions (FASB ASC 830, Foreign Currency Matters)
- Minimum pension liability adjustments (FASB ASC 960, Plan Accounting—Defined Benefit Pension Plans)
- Unrealized gains and losses arising from certain derivative transactions (FASB ASC 815, Derivative and Hedging)
If an entity does not have components of other comprehensive income, FASB ASC 220 does not apply. As a result, most small business clients do not have to apply FASB ASC 220. The requirements of FASB ASC 220 do not apply to not-for-profit organizations that are required to follow the provisions of FASB ASC 958, Not-for-Profit Entities.

FASB ASC 220 does not specify a format for presenting comprehensive income, although it provides three examples:

- Presenting the information in the income statement (after net income)
- Presenting the information in the statement of changes in equity
- Presenting the information in a separate statement of comprehensive income

The wording of the introductory paragraph of the compilation or review report may have to be modified depending on how the accountant chooses to report comprehensive income. If comprehensive income is reported in the income statement, then the title of the statement will need to be modified (Statement of Income and Comprehensive Income). If comprehensive income is reported in a separate statement, then an additional statement will need to be referenced in the report. If comprehensive income is reported in the statement of changes in equity, then no modification to the report is necessary.

However, in compiled financial statements, the presentation of comprehensive income may be omitted by identifying the omission (in much the same way that a statement of cash flows is omitted). Depending on the type of engagement, the omission is identified in the report accompanying the financial statements or in the engagement letter (financial statements not intended for third party use).

Reporting When Supplementary Information Is Included

The following are two common questions that arise when supplementary information is included with the basic financial statements:

- What is considered supplementary information, and where is it placed in the presentation?
- Does the accountant have to modify the standard compilation or review report if supplementary information is included?

The term supplementary information is not defined in SSARSs. Paragraph .03 of AU section 551, Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents (AICPA, Professional Standards, vol. 1), defines this type of information as

- additional details of items in, or related to, the basic financial statements, unless the information has been identified as being part of the basic financial statements.
- consolidating information.
- historical summaries of items extracted from basic financial statements, including graphs prepared on a computer.
- statistical data.
- other material, some of which may be from sources outside the accounting system or outside the entity.

Financial statements often include detailed schedules, summaries, comparisons, or statistical information that are not part of the basic financial statements, such as the following:

- Budgets for an expired period
- Cost of goods sold schedule
- Manufacturing expenses schedule
• Selling expenses
• General and administrative expenses
• Details of marketable securities
• Property and equipment schedule
• Aging analysis of accounts receivable
• Details of sales by product line, territory, or salesman

.39 Normally, supplementary information is separated from the basic financial statements. Most entities present supplementary information on separate pages after the basic financial statements (and notes, if included). It is also a good idea to separate the supplementary information from the basic financial statements by including a title page marked, “Supplementary Information.” If the accountant presents a separate report on the supplementary information, it typically follows the title page.

.40 Paragraph .83 of AR section 100 states that the accountant should clearly indicate the degree of responsibility, if any, he or she is taking with respect to the supplementary information that accompanies the basic financial statements.

.41 When the accountant has compiled both the basic financial statements and other data presented only for supplementary analysis purposes, the compilation report should refer to the other data, or the accountant can issue a separate report on the other data. If a separate report is issued, the report should state that the other data accompanying the financial statements are presented only for supplementary analysis purposes and that the information has been compiled from information that is the representation of management, without audit or review, and the accountant does not express an opinion or any other form of assurance on such data. If the basic financial statements are compiled, then the compilation report can be modified as follows:

We have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings and cash flows for the year then ended, and the accompanying supplementary information contained in schedules A and B, which are presented only for supplementary analysis purposes, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements and supplementary schedules information that is the representation of management. We have not audited or reviewed the accompanying financial statements and supplementary schedules and, accordingly, do not express an opinion or any other form of assurance on them.

.42 If the basic financial statements are reviewed, an explanation should be included in the review report or in a separate report on the other data. The report should state that the review has been made for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with GAAP, and either

• the other data accompanying the financial statements are presented only for supplementary analysis purposes and have been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, and the accountant did not become aware of any material modifications that should be made to such data (that is, the accountant is stating that he or she also reviewed the supplementary information), or

• the other data accompanying the financial statements are presented only for supplementary analysis purposes and have not been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, but were compiled from information that is the representation of management, without audit or review, and the accountant does not express an opinion or any other form of assurance on such data (that is, the accountant is stating that he or she reviewed the financial statements but only compiled the supplementary information).
In any case, the important point to remember is to clearly indicate the degree of responsibility the accountant is taking for any information accompanying the basic financial statements.

**Client Prepared Supplementary Information**

When the supplementary information is prepared or presented solely by the client, the reporting responsibility may not be as obvious as when the accountant assembled or assisted in assembling the information. Client prepared supplementary information is normally included with compiled or reviewed financial statements in one of the following ways:

- The financial statements and the client prepared information are bound by the accountant in his or her firm’s report cover (or typed on the accountant’s letterhead and stapled to the financial statements).
- After the accountant submits the financial statements to the client, the client, in turn, attaches (in some manner) supplementary information and distributes the package to third parties.

**Client Prepared Supplementary Information Bound in the Accountant’s Report Cover**

When the client prepared supplementary information is bound in the accountant’s report cover, a third party would normally conclude that the accountant has some responsibility for the information. Thus, in such a situation, being silent about the accountant’s responsibility for the client prepared supplementary information is not a valid alternative. Paragraph .83 of AR section 100 states, “When the basic financial statements are accompanied by information presented for supplementary analysis purposes, the accountant should clearly indicate the degree of responsibility, if any, he is taking with respect to such information.”

**Supplementary Information Attached by the Client**

The accountant’s reporting responsibility for client prepared supplementary information attached to the financial statements after they are delivered to the client is not directly addressed by SSARSs. Realistically, the accountant has little control over the client’s actions once he or she delivers the report. However, situations do occur when the client clearly communicates to the accountant that the financial statements will be combined with other client prepared information and submitted by the client to third parties, for example, to a bank as part of a loan proposal package. Guidance for these situations can be inferred from AR section 100 and AR section 200, *Reporting on Comparative Financial Statements* (AICPA, *Professional Standards*, vol. 2), that discusses client prepared financial statements included in a client prepared document along with compiled or reviewed financial statements. Basically, this guidance says the client prepared financial statements of some periods that have not been audited, reviewed, or compiled may be presented on separate pages of a document that also contains financial statements of other periods on which the accountant has reported if they are accompanied by a statement that they were not prepared by the accounting firm and the accounting firm assumes no responsibility for them. Absent such a statement, the accountant is advised to consult with his or her attorney to consider what other actions are appropriate. In such situations, the accountant may ask the client to disclose (preferably on a page immediately preceding the data) a statement such as the following:

The supplementary information on pages ____ to ____ has not been audited, reviewed, or compiled by ABC Firm, and ABC Firm assumes no responsibility for this information.

Alternately, the accountant may add the following paragraph to the compilation or review report:

All other information that may be included with (or attached to) the financial statements (and supplementary information) identified in the preceding paragraph has not been audited, reviewed, or compiled by us (me) and, accordingly, we (I) assume no responsibility for it.

**Forecast or Projection Included With Historical Financial Statements**

SSARSs do not apply to any type of prospective information. The accountant is required to report separately on prospective information included with historical financial statements following the reporting
rules in the Statements on Standards for Attestation Engagements. Generally, the accountant will either compile, examine, or apply agreed upon procedures to the prospective information.

.49 An exception to this rule occurs for expired forecasts or projections, that is, presentations that are no longer prospective in nature because the prospective period has expired. An example would be prior year historical financial statements presented alongside the prior year budget. Expired prospective information presented for comparative purposes meets the definition of supplementary information; therefore, AR section 100 applies.

**Pro Forma Information**

.50 The objective of pro forma financial information is to show what the significant direct effects on historical information might have been had a consummated or proposed transaction or event occurred at an earlier date. Pro forma financial information usually is presented by applying certain pro forma adjustments to amounts in the historical financial statements. Such information is frequently used to show the effects of the following:

- Business combinations
- Changes in capitalization
- Dispositions of a significant part of a business
- Changes in the form of business organization
- Proposed sale of securities and application of the proceeds

.51 Although such future or hypothetical transactions may appear prospective in nature, pro forma presentations are essentially historical financial statements that have been recast.

.52 According to paragraph .05 of AR section 120, *Compilation of Pro Forma Financial Information* (AICPA, *Professional Standards*, vol. 2), 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 should also indicate that the pro forma financial information should be read in conjunction with the 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.

.53 If an accountant prepares or assists a client in preparing pro forma financial information, the accountant should consider how the presentation of pro forma financial information will be used. The accountant should also consider the potential of being associated with pro forma financial information and the likelihood that the user may inappropriately infer, through that association, an unintended level of assurance. If the accountant believes that he or she will be associated with the information, the accountant should consider issuing a compilation report so a user will not infer a level of assurance that does not exist.

.54 An engagement to compile pro forma financial information may be undertaken as a separate engagement or in conjunction with a compilation of financial statements. The accountant may agree to compile pro forma financial information if 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). 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.
.55 Additionally, 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 must have been compiled, reviewed, or audited. The accountant’s compilation or review report or the auditor’s report on the historical financial statements should be included (or incorporated by reference) in the document containing the pro forma financial information.

.56 Before issuance of a compilation report on pro forma financial information, the accountant should read such compiled pro forma financial information, including the summary of significant assumptions, and consider whether the information appears to be appropriate in form and free of obvious material errors. In this context, the term error refers to mistakes in the compilation of the pro forma financial information, including arithmetical or clerical mistakes, and mistakes in the application of accounting principles, including disclosures, if presented. The accountant may not report on compiled pro forma financial information if the summary of significant assumptions is not presented. If the accountant reports on compiled pro forma financial information when management elects to omit substantially all disclosures, then the accountant should follow the guidance in paragraph .19 of AR section 100.

.57 When the accountant is engaged to compile or issues a compilation report on pro forma financial information, the basic elements of the report are as follows:

a. An identification of the pro forma financial information.

b. A statement that the compilation was performed in accordance with SSARSs issued by the American Institute of Certified Public Accountants.

c. A reference to the financial statements from which the historical financial information is derived and a statement on whether such financial statements were compiled, reviewed, or audited. (The report on pro forma financial information should refer to any modifications in the accountant’s or auditor’s report on historical financial statements.)

d. A statement that the pro forma financial information was compiled. If the compilation was performed in conjunction with a compilation of the company’s financial statements, the paragraph should so state and indicate the date of the accountant’s compilation report on those financial statements. Furthermore, any departure from the standard report on those statements should also be disclosed if considered relevant to the presentation of the pro forma financial information.

e. A description of the basis on which the pro forma financial information is presented if that basis is not GAAP and a statement that that basis of presentation is a comprehensive basis of accounting other than GAAP.

f. A statement that a compilation is limited to presenting pro forma financial information that is the representation of management (owners).

g. A statement that the pro forma financial information has not been audited or reviewed and, accordingly, the accountant does not express an opinion or any other form of assurance on it.

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

i. A signature of the accounting firm or the accountant as appropriate. (The signature could be manual, stamped, electronic, or typed.)

j. The date of the compilation report. (The date of completion of the compilation should be used as the date of the accountant’s report.)

.58 Each page of the compiled pro forma financial information should include a reference, such as “See Accountant’s Compilation Report.”

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2 The accountant may not report on compiled pro forma financial information if the summary of significant assumptions is not presented. Nothing in this statement should be interpreted to preclude the accountant from reporting on compiled pro forma financial information when management elects to omit substantially all disclosures. In that situation, the accountant should follow the guidance in paragraphs .19–.22 of AR section 100.
Reporting on Charts and Graphs

General

.59 Common examples of charts and graphs prepared for clients include the following:

- Number of days sales in accounts receivable
- Sales by product line
- Operating expenses by plant
- Line of credit usage versus owned inventory

Charts and Graphs That Accompany Financial Statements

.60 When the basic financial statements are accompanied by information in the form of a chart or graph, such information may be considered supplementary information. The accountant may consider the following basic issues:

- Accountants ordinarily should check for consistency if the same information is presented numerically in the basic financial statements and graphically in supplementary information.
- Accountants ordinarily should consider whether the information is presented in a way that is obviously misleading.
- Each chart or graph ordinarily includes a reference to the accountant’s report.

Emphasis Paragraphs

.61 In accordance with paragraph .54 of AR section 100, an accountant may emphasize, in any report on financial statements, a matter disclosed in the financial statements. Such explanatory information should be presented in a separate paragraph of the accountant’s report. Emphasis paragraphs are never required; they may be added solely at the accountant’s discretion. Examples of matters the accountant may wish to emphasize are as follows:

- Uncertainties
- That the entity is a component of a larger business enterprise
- That the entity has had significant transactions with related parties
- Unusually important subsequent events\(^3\)
- Accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period

.62 Because an emphasis of matter paragraph should not be used in lieu of management disclosures, an accountant should not include an emphasis paragraph in a compilation report on financial statements that

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\(^3\) In May 2009, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 165, *Subsequent Events*, which establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. This statement sets forth

1. the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements.
2. the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements.
3. the disclosures that an entity should make about events or transactions that occurred after the balance sheet date.

FASB Statement No. 165 introduces the concept of financial statements being *available to be issued*. It also requires disclosure of the date through which an entity has evaluated subsequent events and the basis for that date (that is, whether that date represents the date the financial statements were issued or were available for issue).

FASB Statement No. 165 is effective for interim or annual financial periods ending after June 15, 2009. For additional information please visit the FASB Web site at www.fasb.org.
omit substantially all disclosures unless the matter is disclosed in the financial statements. For example, the accountant may include an emphasis paragraph on a matter when management has presented selected information, even though substantially, all disclosures have been omitted, as long as the matter discussed in the emphasis paragraph is disclosed in the selected information. The accountant should refer to paragraph .19 of AR section 100 if he or she believes that a disclosure is necessary to keep the financial statements from being misleading.

Going Concern Issues

Full Disclosure Financial Statements

.63 As stated in footnote 30 in paragraph .57 of AR section 100, “Normally, neither an uncertainty, including an uncertainty about an entity’s ability to continue as a going concern, nor an inconsistency in the application of accounting principles would cause the accountant to modify the standard report provided the financial statements appropriately disclose such matters.” According to Interpretation No. 29, “Reporting on an Uncertainty, Including an Uncertainty About an Entity’s Ability to Continue as a Going Concern,” of AR section 100 (AICPA, Professional Standards, vol. 2, AR sec. 9100 par. .120–.129), continuation of an entity as a going concern is assumed in financial reporting in the absence of significant information to the contrary. If, during the performance of compilation or review procedures, evidence or information comes to the accountant’s attention that there may be an uncertainty about the entity’s ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being compiled or reviewed, the accountant should request that management consider the possible effects of the going concern uncertainty on the financial statements, including the need for related disclosure. After management communicates to the accountant the results of its consideration of the possible effects on the financial statements, the accountant should consider the reasonableness of management’s conclusions including the adequacy of the related disclosures, if applicable. If management has not disclosed the matter or the accountant is concerned about the adequacy of management’s disclosure, the accountant should consider whether there is a reasonable possibility that third-party users or other readers of the compiled or reviewed financial statements would be misled into assuming the continuation of the entity. If the accountant determines that the disclosure of the uncertainty regarding the entity’s ability to continue as a going concern is not adequate, he or she should follow the guidance in paragraphs .56–.58 of AR section 100 with respect to departures from GAAP.

.64 If the accountant concludes that management’s disclosure of the uncertainty regarding the entity’s ability to continue as a going concern is adequate, but further decides to include an emphasis of a matter paragraph with respect to the uncertainty in the accountant’s compilation or review report, he or she may use the following language:

As discussed in Note X, certain conditions indicate that the company may be unable to continue as a going concern. The accompanying financial statements do not include any adjustments that might be necessary should the company be unable to continue as a going concern.

Omission of Substantially All Disclosures

.65 The accountant may compile financial statements for a client that omit substantially all disclosures required by GAAP or an other comprehensive basis of accounting, provided that the omission is clearly indicated in the report and is not, to the accountant’s knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such financial statements.4

.66 Because the user is alerted that substantially all disclosures have been omitted from the financial statements (by adding a paragraph to the compilation report to explain the omission), going concern disclosures would not be required.

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4 The accountant cannot review financial statements that omit substantially all disclosures.
Although not required, the going concern matter can be disclosed. In this case, however, the disclosure might be made in the financial statements. Keep in mind that emphasis paragraphs emphasize a matter that is already disclosed in the financial statements. If the going concern matter is the only disclosure included in the financial statements, it should be labeled as “Selected Information—Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included,” rather than “Notes to the Financial Statements.” Once disclosed in the financial statements, the matter can then be emphasized in a separate paragraph of the report.

Subsequent Events

Full Disclosure Financial Statements

Events or transactions sometimes occur subsequent to the balance sheet date, but prior to management’s issuance of financial statements that have a material effect on the financial statements, and therefore require adjustment to or disclosure in the statements. These occurrences are referred to as subsequent events. Evidence or information that a subsequent event that has a material effect on the compiled or reviewed financial statements has occurred may come to the accountant’s attention in the following ways:

- During the performance of compilation or review procedures
- Subsequent to the date of the accountant’s compilation or review report but prior to the release of the report

In either case, the accountant should request that management consider the possible effects on the financial statements including the adequacy of any related disclosure, if applicable. If the accountant determines that the disclosure of the subsequent event in the financial statements or notes is not adequate, he or she should follow the guidance in paragraphs .56–.58 of AR section 100 with respect to departures from GAAP.

Occasionally, a subsequent event has such a material impact on the entity that the accountant may wish to include in his or her compilation or review report an explanatory paragraph directing the reader’s attention to the event and its effects. Such an emphasis of matter paragraph may be added, at the accountant’s discretion, provided that the matter is disclosed in the financial statements. See paragraphs .65–.66 in this section of the manual for additional discussion regarding emphasis of matter paragraphs.

Omission of Substantially All Disclosures

The accountant may compile financial statements for a client that omit substantially all disclosures required by GAAP or an other comprehensive basis of accounting, provided that the omission is clearly indicated in the report and is not, to the accountant’s knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such financial statements.

Because the user is alerted that substantially all disclosures have been omitted from the financial statements (by adding a paragraph to the compilation report to explain the omission), subsequent event disclosures would not be required in the accountant’s report.

Although not required, a subsequent event can be disclosed. In this case, however, the disclosure might be made in the financial statements. Keep in mind that emphasis paragraphs emphasize a matter that is already disclosed in the financial statements. If the subsequent event matter is the only disclosure included in the financial statements, it should be labeled as “Selected Information—Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included,” rather than “Notes to the Financial Statements.” Once disclosed in the financial statements, the matter can then be emphasized in a separate paragraph of the report.

5 See footnote 3.
6 See footnote 4.
Reporting When There Is a Scope Limitation

.73 Scope limitations occur in audit engagements when the auditor is prevented from applying generally accepted auditing standards because of limitations imposed by the client or caused by other circumstances. When an auditor encounters a scope limitation, he or she issues an “except for” opinion or disclaimer of opinion. However, AR section 100 does not permit such reporting.

.74 Scope limitations can occur in SSAR5 engagements, especially in initial review engagements. In those cases, it is not unusual for the accountant to raise questions about the reasonableness of amounts included in the financial statements. Often, due to the timing of the engagement or inadequate accounting records, he or she may also be unable to apply analytical procedures to obtain limited assurance. Paragraph .51 of AR section 100 notes that when an accountant is unable to perform inquiry and analytical procedures necessary for a review or when the client does not provide the accountant with a representation letter, the review will be incomplete, and a review report cannot be issued. In this situation, the accountant should consider whether the scope limitation also precludes him or her from issuing a compilation report.

.75 In considering the limitations of the scope limitation, the accountant should evaluate the possibility that the information affected by the scope limitation is incorrect, incomplete, or otherwise unsatisfactory. This evaluation is a matter of professional judgment. If the client is unable to provide additional or revised information due to factors beyond his or her control, a step-down to a compilation is acceptable. The accountant may consider the following:

- Whether the reason for the scope limitation seems logical
- Whether the scope restriction significantly impairs the usefulness of the financial statements

.76 In deciding whether it would be appropriate to issue a compilation report when a scope restriction precludes a review report, the accountant should determine if the scope restriction is client imposed. Paragraph .10 of AR section 100 states that the accountant should withdraw from the engagement if the client refuses to provide additional or revised information. A scope restriction resulting from inadequate accounting records is considered a client imposed restriction. Although the restriction may be unintentional, the maintenance of adequate accounting records is within the client’s control. Situations when the client is unable to provide additional or revised information are rare. One such situation may be when accounting records have been destroyed.

.77 When there has been a scope restriction that precludes a review report, and the accountant decides to issue a compilation report, paragraph .91 of AR section 100 indicates he or she should issue an appropriate compilation report without any reference to the scope restriction.

.78 If the accountant is unable to obtain the limited assurance required for a review and decides it would not be appropriate to issue a compilation report, he or she can try to provide other accounting information to the client, short of submitting financial statements. For example, a working trial balance may satisfy the client’s needs.

Reporting on Financial Statements Included in Management Consulting Services Reports

General

.79 Unaudited financial statements are often included in reports on findings in management consulting services engagements (MCS reports). A question often arises as to what reporting responsibility the accountant has on those historical financial statements.

.80 The accountant should not submit unaudited financial statements of a nonissuer to his or her client or a third party unless, at a minimum, he or she complies with the provisions of AR section 100 applicable to
a compilation engagement. This requirement extends to unaudited financial statements included in MCS reports.

Financial Statements Compiled or Reviewed by Another Accountant

.81 As discussed in paragraph .17 of AR section 200, when the financial statements of a prior period have been compiled or reviewed by a predecessor whose report is not presented, and the successor has not compiled or reviewed those financial statements, the successor should make reference in an additional paragraph(s) of his report on the current period financial statements to the predecessor’s report on the prior period financial statements. This reference should include the following matters:

a. A statement that the financial statements of the prior period were compiled or reviewed by another accountant (other accountants). The successor accountant should not disclose the name of the other accountant in his or her report; however, the successor accountant may name the predecessor accountant if the predecessor accountant’s practice was acquired by or merged with that of the successor accountant

b. The date of his (their) report

c. A description of the standard form of disclaimer or limited assurance, as applicable, included in the report

d. A description or a quotation of any modifications of the standard compilation or review report and of any paragraphs emphasizing a matter regarding the financial statements

.82 An example of a paragraph that might be added to the MCS report when the other accountant issued a standard compilation report on the financial statements follows:

The 20X1 financial statements of XYZ Company were compiled by other accountants, whose report dated February 1, 20X2 stated that they did not express an opinion or any other form of assurance on those statements.

.83 An example of a paragraph that might be added to the MCS report when the other accountant issued a standard review report on the financial statements follows:

The 20X1 financial statements of XYZ Company were reviewed by other accountants, whose report dated February 1, 20X2, stated that they were not aware of any material modifications that should be made to those statements in order for them to be in conformity with generally accepted accounting principles.

Client Prepared Financial Statements

.84 If the MCS report contains client prepared financial statements, the accountant is not required to compile and report in those statements. In that case, professional standards do not require that the accountant mention those statements in the MCS report at all. However, many accountants compile and report on such statements because they are included in a document (MCS report) that bears their name and because a compilation is the lowest level of service with which they would want to be associated. If the accountant decides not to compile the statements, he or she may add a statement to the MCS report to clarify his or her responsibility for the financial statements. Such a statement might be worded as follows:

We have not compiled, reviewed, or audited the financial statements presented on pages ___ to ___ and, accordingly, we assume no responsibility for them.

Reporting When Only One Financial Statement Is Presented

.85 An accountant may issue a compilation or review report on a single financial statement, such as a balance sheet. Engagements to report on a single financial statement are limited reporting engagements, not scope restrictions.
Reporting on Comparative Financial Statements

.86 AR section 200 establishes standards for reporting on comparative financial statements of a nonissuer when financial statements of one or more periods presented have been compiled and reported on or reviewed in accordance with AR section 100. Reporting is simple unless a change of accountants has occurred, the level of service (compilation or review) differs from period to period, or a change in the nonissuer status of the entity has occurred. In these situations, the accountant may face some rather complex reporting decisions. Because the accountant may not face these complexities often, applying the guidance in AR section 200 can be daunting.

.87 The following definitions from paragraph .07 of AR section 200 may facilitate reporting on comparative financial statements:

updated report. A continuing accountant issues this kind of report, which considers new information from the current engagement and re-expresses the previous conclusions or expresses different conclusions on the prior period financial statements as of the current report date.

reissued report. Issued subsequent to the date of the original report but bears the same date as the original report; a reissued report may need to be revised and dual dated for the effects of specific events.

General

.88 When comparative financial statements of a nonissuer are presented, the accountant should issue a report covering each period presented. If the accountant becomes aware that financial statements of other periods that have not been audited, reviewed, or compiled are presented in comparative form in a document containing financial statements that he or she has reported on, and the accountant’s name or report is used, the accountant should advise the client that the use of his or her name or report is inappropriate. The accountant may also wish to consult with an attorney.

.89 The accountant should not report on comparative statements when statements for one or more of the periods, but not all, omit substantially all disclosures.

Practice Tip

Financial statements in columnar form with disclosures are comparative; financial statements that omit substantially all disclosures are comparative; but financial statements with disclosures are not comparative to financial statements without disclosures.

Continuing Accountant’s Standard Report

.90 A continuing accountant who performs the same or higher level of service on the current period financial statements should update his or her report on the prior period financial statements.

.91 A continuing accountant who performs a lower level of service (20X2 compiled, 20X1 reviewed) should either

- include a separate paragraph in the report describing the responsibility for the prior period financial statements.
- reissue the report on the prior period financial statements.

.92 If the first option indicated in the paragraph above is selected, the description should include the original date of the report and should state that no review procedures were performed after that date.

.93 If the second option is selected, the report may be
• a combined compilation and reissued review report. (The combined report should state that no review procedures were performed after the date of the review report.)
• presented separately.

Continuing Accountant’s Changed Reference to GAAP

.94 The accountant should consider the effects on the prior period report of circumstances or events that came to his or her attention. When the accountant’s report contains a changed reference to a GAAP departure, the report should include a separate paragraph indicating the following:
• Date of previous report
• Circumstances or events that caused the change
• If applicable, that the prior period financial statements have been changed

Predecessor’s Compilation or Review Report

.95 A predecessor accountant is not required to, but may choose to reissue his or her report. If the predecessor’s compilation or review report is not presented, the successor should either
• make reference to the predecessor’s report in accordance with the provisions of paragraphs .17–.19 of AR section 200.
• perform a compilation, review, or audit of the prior period financial statements and report thereon.

.96 If “reference to the predecessor’s report” option is selected, the successor’s reference should include
• a statement that the prior period financial statements were compiled or reviewed by another accountant(s) (without identifying the predecessor by name).\(^7\)
• the date of prior accountant’s report.
• a description of the disclaimer or limited assurance report.
• a description or quotation of any report modification or emphasis paragraphs.

.97 According to paragraph .20 of AR section 200, if the predecessor report is to be reissued, before reissuing, the predecessor should consider
• the current form and presentation of the prior period financial statements.
• subsequent events not previously known.
• changes in the financial statements that alter modifications to the report.

.98 The predecessor should also perform the following procedures:
• Read the current period financial statements and the successor’s report.
• Compare the prior period financial statements (\(a\)) with those previously issued and (\(b\)) with the current period.
• Obtain a letter from the successor indicating whether he or she is aware of any matter that affects the prior period financial statements. The predecessor should not refer in his reissued report to this letter or the report of the successor.

.99 If the predecessor becomes aware of any matter that affects the prior period financial statements, he or she should

\(^7\) The successor accountant should not name the predecessor accountant in his or her report; however, the successor accountant may name the predecessor accountant if the predecessor accountant’s practice was acquired by, or merged with that of the successor accountant.
make inquiries or perform analytical procedures similar to those that would have been applied to the information if it had been known at the report date.

perform other procedures considered necessary such as discussing the matter with the successor or reviewing the successor’s working papers.

.100 When reissuing the report, the predecessor should use the date of the previous report. However, if the financial statements are revised, the report should be dual dated. Also, if the financial statements are revised, the predecessor should obtain a written statement from the former client describing the new information and its effect on the prior period financial statements.

.101 If the predecessor is unable to complete the reissue procedures described above, he or she should not reissue the report and may wish to consult with an attorney.

Restated Prior Period Financial Statements

.102 When prior period financial statements have been restated, the predecessor accountant would normally reissue his or her report following the guidance in paragraph .22 of AR section 200. If the predecessor decides not to reissue his or her report, the successor accountant may be engaged to report on the financial statements for the prior year. If the predecessor accountant does not reissue his or her report and the successor accountant is not engaged to report on the prior year financial statements, the successor accountant should indicate in the introductory paragraph of his or her compilation or review report that a predecessor accountant reported on the financial statements of the prior period before restatement. In addition, if the successor accountant is engaged to compile or review the restatement adjustment(s), he or she may also indicate in the accountant’s report that he or she compiled or reviewed the adjustment(s) that was (were) applied to restate prior year financial statements.

Reporting When Prior Period Is Audited

.103 The accountant should issue a compilation or review report on the current period financial statements and either

• reissue the audit report on the prior period or

• add a separate paragraph to the current period report that includes the following information:
  — The financial statements of the prior period were audited.
  — The date of the previous audit report.
  — The type of opinion expressed previously.
  — Substantive reasons for other than unqualified opinion.
  — No audit procedures were performed after the date of the previous audit report.

Reporting on Financial Statements That Previously Did Not Omit Substantially All Disclosures

.104 The accountant may report on comparative financial statements that omit substantially all disclosures even if the prior period statements were originally compiled, reviewed, or audited (with disclosures) provided that his or her report includes an additional paragraph stating the nature of the previous service and the date of the previous report.

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8 Paragraphs .10–.11 of AR section 400, *Communications Between Predecessor and Successor Accountants* (AICPA, *Professional Standards*, vol. 2), establish requirements and provide guidance regarding communication to the predecessor accountant with respect to information that leads the successor accountant to believe that the financial statements reported on by the predecessor accountant may require revision.
Change of Accountants—Reporting Following a Merger or Purchase of a Firm

.105 When there has been a merger or purchase of a firm, the new firm or purchaser should report as a successor accountant and apply the guidance in AR section 200. Basically, it permits the successor to (a) make reference to the old or acquired firm’s report or (b) assume compilation, review, or audit responsibility for the prior period financial statements. The successor accountant may name the predecessor accountant if the predecessor accountant’s practice was acquired by or merged with that of the successor accountant.

Change of Accountants—Predecessor Accountant Has Ceased Operations

.106 If the prior period financial statements were compiled or reviewed and have not been restated, the notice states that the successor accountant should add a paragraph to the report on the current year financial statements that includes the following:

- A statement that the prior period financial statements were compiled or reviewed by another accountant who has ceased operations
- The date of the predecessor accountant’s report
- A description of the standard form of disclaimer or limited assurance, as applicable, included in the report
- A description or quotation of any modifications of the standard report and any paragraphs emphasizing a matter regarding the financial statements

.107 If the prior period financial statements were audited and have not been restated, the successor accountant should add a paragraph to the report on the current period financial statements that indicates the following:

- That the prior period financial statements were audited by another firm
- The date of the predecessor’s report
- The type of opinion issued by the predecessor
- If the opinion was other than unqualified, the substantive reasons therefore
- That no auditing procedures were performed after the date of the predecessor’s report

.108 If the prior period financial statements have been restated, the successor accountant may be engaged to report on the financial statements for the prior year. If the successor accountant is not engaged to report on the financial statements for the prior year, the successor accountant should indicate in the introductory paragraph of his compilation or review report that a predecessor accountant reported on the financial statements of the prior period before restatement. In addition, if the successor accountant is engaged to compile or review the restatement adjustment(s), he or she may also indicate in the accountant’s report that he or she compiled or reviewed the adjustment(s) that was (were) applied to restate prior year financial statements.

AR Section 200 Summary

.109 AR section 200 may be rather complex for some accountants. The following summary decision aid helps simplify the report decision process in AR section 200. The comparative statements are for years 20X5 and 20X6.

1. If 20X6 is audited, SASs apply.
2. For continuing accountant:
   a. If 20X6 level of service is equal to or higher than 20X5, update report.
   b. If 20X6 is lower level of service, either refer to or reissue prior report.
3. For successor accountant:
   
   a. If predecessor does not reissue, refer to report of predecessor or perform review or compilation of 20X5.
   
   b. If financial statements are restated because of an error and predecessor doesn’t report on restated financials, perform review or compilation of 20X5.

**Reporting When Other Accountants Have Audited or Reviewed a Component**

.110 If other accountants are engaged to audit or review the financial statements of a division, branch, subsidiary, or other investee, the accountant may request reports from the other accountants as a basis, in part, for his or her review report on the financial statements of the reporting entity. The accountant may decide to refer to the work of the other accountants in the review report. If such a reference is made, the report should indicate the magnitude of the portion of the financial statements audited or reviewed by the other accountants.

**Preliminary Financial Statement Drafts**

.111 Interpretation No. 17, “Submitting Draft Financial Statements,” of AR section 100 (AICPA, Professional Standards, vol. 2, AR sec. 9100 par. .61–.62) states that an accountant can submit draft financial statements without attaching a compilation or review report as long as

- he or she intends to submit final financial statements, and
- he or she labels each page of the draft financial statements with words such as Draft, Preliminary Draft, Draft—Subject to Change, or Working Draft.

.112 In the rare circumstances where the accountant submits drafts but never issues the final statements, the interpretation suggests that the accountant document the reasons why. The interpretation reinforces the fact that preliminary drafts should not be used as a means of circumventing the reporting standards of SSARSs.

[The next page is 2611.]
AAM Section 2610

Accountants’ Reports on Compilation of Financial Statements of a Nonissuer*

.01 Accountants’ Standard Report

Stockholders and Board of Directors

[Company]

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (the owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

January 28, 20X7

[Signature of CPA]

[Source: Paragraph .16 of AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2)]

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1 In February 2009, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 18, Applicability of Statements on Standards for Accounting and Review Services (AICPA, Professional Standards, vol. 2), which amends paragraph .01 of AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2). SSARS No. 18 revises the applicability of the SSARSs so that SSARSs do not apply when the provisions of AU section 722, Interim Financial Information (AICPA, Professional Standards, vol. 1), apply. SSARS No. 18 is effective for compilations and reviews of financial statements for periods beginning after December 15, 2009, with early application permitted. This manual will be updated for SSARS No. 18 in the next edition.

2 If the statement of comprehensive income is included, the first paragraph of the report should also refer to this statement.

1 Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 505, Equity, requires the disclosure of a change in capital. This can be accomplished by the preparation of a separate statement, in the notes to the financial statements, or as part of another basic statement. If the accountant does not include a statement of retained earnings as a separate statement, reference in the compilation report is not needed.
Stockholders and Board of Directors

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (the owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

Management has elected to omit substantially all disclosures (and the statement of cash flows) required by GAAP. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the Company’s financial position, results of operations, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

January 28, 20X7

[Signature of CPA]

[Source: Paragraph .21 of AR section 100]

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3 If the statement of cash flows is omitted, the first and third paragraphs of the report should be modified accordingly.

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.03 Accountants Not Independent

Stockholders and Board of Directors

[Company]

[Address]

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income, retained earnings,\(^5\) and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (the owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

I am (We are) not independent with respect to [Company].

January 28, 20X7

[Signature of CPA]

[Source: Paragraphs .16 and .23 of AR section 100]

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\(^4\) If the statement of comprehensive income is included, the first paragraph of the report should also refer to this statement.

\(^5\) FASB ASC 505 requires the disclosure of a change in capital. This can be accomplished by the preparation of a separate statement, in the notes to the financial statements, or as part of another basic statement. If the accountant does not include a statement of retained earnings as a separate statement, reference in the compilation report is not needed.
.04 Departure From GAAP—Omission of Statement of Cash Flows

Stockholders and Board of Directors

[Company]

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income and retained earnings for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (the owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them. However, I (we) did become aware of a departure from generally accepted accounting principles that is described in the following paragraph.

A statement of cash flows for the year ended December 31, 20X6, has not been presented. Generally accepted accounting principles require that such a statement be presented when the financial statements purport to present financial position and results of operations.

January 28, 20X7

[Signature of CPA]

[Source: Paragraph .57 of AR section 100]
.05 Departure From GAAP—Accounting Principles Not Generally Accepted

Stockholders and Board of Directors

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of management [owners]. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them. However, I (we) did become aware of a departure from generally accepted accounting principles that is described in the following paragraph.

As disclosed in Note X to the financial statements, generally accepted accounting principles require that land be stated at cost. Management has informed me (us) that the company has stated its land at appraised value and that, if generally accepted accounting principles had been followed, the land account and stockholders’ equity would have been decreased by $500,000.

January 28, 20X7

[Signature of CPA]

[Source: Paragraph .57 of AR section 100]
.06 Compilation Report With Departure From GAAP and Omission of Substantially All Disclosures

Stockholders and Board of Directors

[Company]

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (the owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them. However, I (We) did become aware of a departure from generally accepted accounting principles that is described in the following paragraph.

Generally accepted accounting principles require that [describe requirement]. Management has informed me (us) that the company has [describe departure], which is not in accordance with generally accepted accounting principles. Management has not determined the effect of the departure from generally accepted accounting principles on the accompanying balance sheet. The accompanying statements of income, retained earnings, and cash flows would not be affected by the departure.

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

January 28, 20X7

[Signature of CPA]

[Source: Derived from paragraphs .20 and .57 of AR section 100]
Compilation Report—One Financial Statement

Stockholders and Board of Directors

[Company]

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20X6, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. I (We) have not audited or reviewed the accompanying balance sheet and, accordingly, do not express an opinion or any other form of assurance on it.

January 28, 20X7

[Signature of CPA]

[Source: Derived from paragraph .14 of AR section 100]
.08 Continuing Accountants’ Report on Comparative Statements—Both Periods Compiled

Stockholders and Board of Directors

[Company]

I (We) have compiled the accompanying balance sheets of [Company] as of December 31, 20X6 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

January 28, 20X7

[Signature of CPA]

[Source: Paragraph .09 of AR section 200, Reporting on Comparative Financial Statements (AICPA, Professional Standards, vol. 2)]

Stockholders and Board of Directors

[Company]

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20X6 and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

The accompanying 20X5 financial statements of [Company] were previously reviewed by me (us), and my (our) report dated [Date] stated that I was (we were) not aware of any material modifications that should be made to those statements in order for them to be in conformity with generally accepted accounting principles. I (We) have not performed any procedures in connection with that review engagement after the date of my (our) report on the [Year] financial statements.

January 28, 20X7

[Signature of CPA]

[Source: Paragraphs .09 and .12 of AR section 200]
.10 Continuing Accountants’ Report on Comparative Statements—Both Periods Compiled With Restatement of Prior Period Financial Statements

Stockholders and Board of Directors

[Company]

I (We) have compiled the accompanying balance sheets of [Company] as of December 31, 20X6 and December 31, 20X5, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

In my (our) previous compilation report dated [Date], on the 20X5 financial statements, I (we) referred to a departure from generally accepted accounting principles because the company [describe departure]. However, as disclosed in Note [Number], the company has restated its 20X5 financial statements to [describe correction] in accordance with generally accepted accounting principles.

January 28, 20X7

[Signature of CPA]

[Source: Paragraphs .09 and .15 of AR section 200]

Stockholders and Board of Directors

[Company]

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

The 20X5 financial statements of [Company] were compiled by other accountants whose report, dated [Date], stated that they did not express an opinion or any other form of assurance on those statements.

January 28, 20X7

[Signature of Successor CPA]

[Source: Paragraphs .09 and .19 of AR section 200]

Stockholders and Board of Directors

[Company]

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

The 20X5 financial statements of [Company] were reviewed by other accountants whose report, dated [Date], stated that they were not aware of any material modifications that should be made to those statements in order for them to be in conformity with generally accepted accounting principles.

January 28, 20X7

[Signature of Successor CPA]

[Source: Paragraphs .09 and .18 of AR section 200]

Stockholders and Board of Directors

[Company]

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

The accompanying 2005 financial statements were audited by me (us) and I (we) expressed an unqualified opinion on them in my (our) report dated [Date]. I (We) have not performed any auditing procedures since that date.

January 28, 20X7

[Signature of CPA]

[Source: Paragraphs .09 and .29 of AR section 200]
Stockholders and Board of Directors

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income, retained earnings, and cash flows for the year then ended, and the other information appearing on pages [Numbers], which is presented only for supplementary analysis purposes, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements and supplementary schedules information that is the representation of management. I (We) have not audited or reviewed the accompanying financial statements and other information and, accordingly, do not express an opinion or any other form of assurance on them.

January 28, 20X7

[Signature of CPA]

[Source: Paragraphs .16 and .83 of AR section 100]
.15 Compilation Report on Pro Forma Financial Information

Stockholders and Board of Directors

[Company]

I (we) have compiled the accompanying pro forma financial information as of and for the year ended December 31, 20X6, reflecting the business combination of the Company and ABC Company in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA. The historical condensed financial statements are derived from the historical unaudited financial statements of XYZ Company, which were compiled by me (us), and of ABC Company, which were compiled by another (other) accountant(s).8

A compilation is limited to presenting pro forma financial information that is the representation of management (owners). I (we) have not audited or reviewed the accompanying pro forma financial information and, accordingly, do not express an opinion or any other form of assurance on it.

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 financial information is 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.

[If the presentation does not include all applicable disclosures, the following paragraph should be added.]9

Management has elected to omit all of the disclosures ordinarily included in pro forma financial information. The omitted disclosures might have added significant information regarding the company’s pro forma financial position and results of operations. Accordingly, this pro forma financial information is not designed for those who are not informed about such matters.

January XX, 20X7

[Signature of CPA]

[Source: Paragraph .15 of AR section 120, Compilation of Pro Forma Financial Information (AICPA, Professional Standards, vol. 2)]

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8 Where one set of historical financial statements is audited or reviewed and the other is audited, reviewed, or compiled, wording similar to the following would be appropriate:

The historical condensed financial statements are derived from the historical financial statements of XYZ Company, which were compiled by me (us), and of ABC Company, which were reviewed by another (other) accountant(s), appearing elsewhere herein (or incorporated by reference).

If either accountant’s review report or auditor’s report includes an explanatory paragraph or is modified, that fact should be referred to within this report.

9 The accountant may not report on compiled pro forma financial information if the summary of significant assumptions is not presented.
Compilation and Review—Emphasis of a Going Concern Uncertainty

Stockholders and Board of Directors

[Company]

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

As discussed in Note [Number], certain conditions indicate that the company may be unable to continue as a going concern. The accompanying financial statements do not include any adjustments to the financial statements that might be necessary should the company be unable to continue as a going concern.

January 28, 20X7

[Signature of CPA]

[Source: Paragraph .16 of AR section 100 and Interpretation No. 29, “Reporting on an Uncertainty, Including an Uncertainty About an Entity’s Ability to Continue as a Going Concern,” of AR section 100 (AICPA, Professional Standards, vol. 2, AR sec. 9100 par. .120–.129)]

[The next page is 2641.]

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10 See footnote 4.
11 See footnote 5.
AAM Section 2620

Accountants’ Reports on Review of Financial Statements of a Nonissuer

.01 Accountants’ Standard Report

Stockholders and Board of Directors

[Company]

I (We) have reviewed the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA. All information included in these financial statements is the representation of the management (owners) of [Company].

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

January 28, 20X7

[Signature of CPA]

[Source: Paragraph .49 of AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2)]

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1 In February 2009, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 18, Applicability of Statements on Standards for Accounting and Review Services (AICPA, Professional Standards, vol. 2), which amends paragraph .01 of AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2). SSARS No. 18 revises the applicability of the SSARSs so that SSARSs do not apply when the provisions of AU section 722, Interim Financial Information (AICPA, Professional Standards, vol. 1), apply. SSARS No. 18 is effective for compilations and reviews of financial statements for periods beginning after December 15, 2009, with early application permitted. This manual will be updated for SSARS No. 18 in the next edition.

2 If the statement of comprehensive income is included, the first paragraph of the report should also refer to this statement.

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Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 505, Equity, requires the disclosure of a change in capital. This can be accomplished by the preparation of a separate statement, in the notes to the financial statements, or as part of another basic statement. If the accountant does not include a statement of retained earnings as a separate statement, reference in the review report is not needed.
.02 Departure From GAAP

Stockholders and Board of Directors

[Company]

I (we) have reviewed the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA. All information included in these financial statements is the representation of the management (owners) of [Company].

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, with the exception of the matter described in the following paragraph, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

As disclosed in Note X to the financial statements, generally accepted accounting principles require investments in marketable equity securities be reported at fair value. Management has informed us that the Company has stated these investments at cost, which is not in accordance with generally accepted accounting principles. If generally accepted accounting principles had been followed, the investment in marketable equity securities and stockholders’ equity would have decreased by $70,000.

January 28, 20X7

[Signature of CPA]

[Source: Paragraph .57 of AR section 100]
.03 Departure From GAAP—Omission of Statement of Cash Flows

Stockholders and Board of Directors

[Company]

I (we) have reviewed the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income and retained earnings for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA. All information included in these financial statements is the representation of the management (owners) of [Company].

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, with the exception of the matter described in the following paragraph, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

A statement of cash flows for the year ended December 31, 20X6, has not been presented. Generally accepted accounting principles require that such a statement be presented when financial statements purport to present financial position and results of operations.

January 28, 20X7

[Signature of CPA]

[Source: Paragraph .57 of AR section 100]
.04 Continuing Accountant’s Report on Comparative Statements—Both Periods Reviewed

Stockholders and Board of Directors

[Company]

I (we) have reviewed the accompanying balance sheets of [Company] as of December 31, 20X6 and 20X5, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA. All information included in these financial statements is the representation of the management (owners) of [Company].

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

January 28, 20X7

[Signature of CPA]

[Source: Paragraph .09 of AR section 200, Reporting on Comparative Financial Statements (AICPA, Professional Standards, vol. 2)]
.05 Continuing Accountant’s Report on Comparative Statements—Current Period Reviewed and Prior Period Compiled

Stockholders and Board of Directors

[Company]

I (we) have reviewed the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA. All information included in these financial statements is the representation of the management (owners) of [Company].

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the 20X6 financial statements in order for them to be in conformity with generally accepted accounting principles.

The accompanying 20X5 financial statements of [Company] were compiled by me (us). A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (we) have not audited or reviewed the 20X5 financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

January 28, 20X7

[Signature of CPA]

[Source: Paragraph .10 of AR section 200]
.06 Continuing Accountant’s Report on Comparative Statements—Both Periods Reviewed With Restatement of Prior Period Financial Statements

Stockholders and Board of Directors

[Company]

I (we) have reviewed the accompanying balance sheets of [Company] as of December 31, 20X6 and 20X5, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA. All information included in these financial statements is the representation of the management (owners) of [Company].

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

In my (our) previous review report dated March 1, 20X6, on the 20X5 financial statements, I (we) referred to a departure from generally accepted accounting principles because the company [describe departure]. As discussed in Note [Number], however, the company has restated its 20X5 financial statements to [describe correction] in accordance with generally accepted accounting principles.

January 28, 20X7

[Signature of CPA]

[Source: Paragraphs .09 and .15 of AR section 200]

Stockholders and Board of Directors

[Company]

I (we) have reviewed the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA. All information included in these financial statements is the representation of management (owners) of [Company].

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

The 20X5 financial statements of [Company] were reviewed by other accountants whose report, dated March 1, 20X6, stated that they were not aware of any material modifications that should be made to those financial statements in order for them to be in conformity with generally accepted accounting principles.

January 28, 20X7

[Signature of Successor CPA]

[Source: Paragraphs .09 and .18 of AR section 200]
I (we) have reviewed the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA. All information included in these financial statements is the representation of management (owners) of [Company].

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

The 20X5 financial statements of [Company] were compiled by other accountants whose report, dated March 1, 20X6, stated that they did not express an opinion or any other form of assurance on those statements.

January 28, 20X7

[Signature of Successor CPA]
.09 Continuing Accountant’s Report on Comparative Statements—Current Period Reviewed With
Reference to Audit Report on Prior Period

Stockholders and Board of Directors

[Company]

I (we) have reviewed the accompanying balance sheet of [Company] as of December 31, 20X6, and the related
statements of income, retained earnings, and cash flows for the year then ended, in accordance with
Statements on Standards for Accounting and Review Services issued by the AICPA. All information included
in these financial statements is the representation of the management (owners) of [Company].

A review consists principally of inquiries of company personnel and analytical procedures applied to financial
data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards,
the objective of which is the expression of an opinion regarding the financial statements taken as a whole.
Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the
accompanying financial statements in order for them to be in conformity with generally accepted accounting
principles.

The accompanying 2005 financial statements were audited by (me) us, and I (we) expressed an unqualified
opinion on them in my (our) report dated March 1, 20X6. I (we) have not performed any auditing procedures
since that date.

January 28, 20X7

[Signature of CPA]

[Source: Paragraphs .09 and .29 of AR section 200]
.10 Review Report—Supplementary Information Subjected to Review Procedures\(^3\)

Stockholders and Board of Directors

[Company]

I (we) have reviewed the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income, retained earnings,\(^4\) and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA. All information included in these financial statements is the representation of the management (owners) of [Company].

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

My (our) review was made for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles. The other information appearing on pages [Numbers] are presented only for supplementary analysis purposes. This other information has been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, and I (we) are not aware of any material modifications that should be made thereto.

January 28, 20X7

[Signature of CPA]

[Source: Paragraphs .49 and .83 of AR section 100]

\(^3\) See footnote 1.

\(^4\) See footnote 2.
.11 Review Report—Supplementary Information Not Subjected to Review Procedures

Stockholders and Board of Directors

[Company]

I (we) have reviewed the accompanying balance sheet of [Company] for the year ended December 31, 20X6, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA. All information included in these financial statements is the representation of the management (owners) of [Company].

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

My (Our) review was made for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles. The other information included on pages [Numbers] is not a required part of the basic financial statements but is supplementary information presented by the Company. Such information is presented only for analysis purposes and has not been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements. This information was compiled from information that is the representation of management, without audit or review. Accordingly, I (we) do not express an opinion or any other form of assurance on these data.

January 28, 20X7

[Signature of CPA]

[Source: Paragraphs .49 and .83 of AR section 100]
.12 Review Report—Emphasis of a Going Concern Uncertainty

Stockholders and Board of Directors

[Company]

I (we) have reviewed the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA. All information included in these financial statements is the representation of the management (owners) of [Company].

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

As discussed in Note [Number], certain conditions indicate that the company may be unable to continue as a going concern. The accompanying financial statements do not include any adjustments to the financial statements that might be necessary should the Company be unable to continue as a going concern.

January 28, 20X7

[Signature of CPA]

[Source: Paragraph .49 of AR section 100 and Interpretation No. 29, “Reporting on an Uncertainty, Including an Uncertainty About an Entity’s Ability to Continue as a Going Concern,” of AR section 100 (AICPA, Professional Standards, vol. 2, AR sec. 9100 par. .120–.129)]

[The next page is 2661.]
Other Comprehensive Bases of Accounting

.01 Paragraph .04 of AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2), defines other comprehensive basis of accounting (OCBOA) as a definite set of criteria, other than generally accepted accounting principles (GAAP), having substantial support underlying the preparation of financial statements prepared pursuant to that basis. Paragraph .04 of AR section 100 recognizes the following as OCBOA:

- The basis of accounting the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency which has jurisdiction over the entity. An example is a basis of accounting insurance companies use pursuant to the rules of a state insurance commission.
- The basis of accounting the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements.
- The cash basis of accounting and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets). Ordinarily, a modification would have substantial support if the method is equivalent to the accrual basis of accounting for that item and if the method is not illogical. If modifications to the cash basis of accounting do not have substantial support, the accountant should appropriately modify his or her report in accordance with the guidance in paragraphs .56–.58 of AR section 100. If the modifications are so extensive that the modified “cash basis” statements are, in the accountant’s judgment, equivalent to financial statements on the accrual basis, the statements should be considered GAAP basis. The accountant may use the standard form of report, modified as appropriate, because of the departures from generally accepted accounting principles.

Deciding When to Use an OCBOA

.02 OCBOA financial statements are beneficial to clients for many reasons. Among them is the idea that the client does not need to consider the measurement requirements of GAAP for OCBOA financial statements.

.03 The client might consider the following characteristics when deciding whether to prepare cash or tax basis financial statements:

- There are no third party users of financial statements (for example, the entity is closely held with no third party debt).
- The entity’s debt is secured rather than unsecured.
- The entity’s creditors do not require GAAP financial statements.
- The cost of complying with GAAP would exceed the benefits.
- The owners and managers are closely involved in the day-to-day operations of the business and have a fairly accurate picture of the entity’s financial position.

* In February 2009, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 18, Applicability of Statements on Standards for Accounting and Review Services (AICPA, Professional Standards, vol. 2), which amends paragraph .01 of AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2). SSARS No. 18 revises the applicability of the SSARSs so that SSARSs do not apply when the provisions of AU section 722, Interim Financial Information (AICPA, Professional Standards, vol. 1), apply. SSARS No. 18 is effective for compilations and reviews of financial statements for periods beginning after December 15, 2009, with early application permitted. This manual will be updated for SSARS No. 18 in the next edition.
• The business’s owners are primarily interested in cash flows.
• The owners are primarily interested in the tax implications of transactions.
• Capital expenditures and long-term financing are not significant.
• Internal Revenue Code rules do not require the entity to prepare its tax return on the accrual basis.

.04 The client might consider the following issues:
• Does the entity have inventory? If so, the pure cash basis may not be helpful.
• What basis of accounting does the entity use in preparing its income tax return? If the accrual basis is used, preparing financial statements on the same basis makes sense.
• Is the entity highly leveraged? Lenders may require GAAP financial statements.
• Are there outside investors? GAAP financial statements may provide information required by such users.
• Does the entity’s cash flow parallel its income and expenses? The pure cash basis may be appropriate.
• Does the entity anticipate going public? If so, the entity will need a history of GAAP financial statements.
• Was the entity formed for tax purposes? If yes, the owners are probably interested in the tax effects of transactions, and the income tax basis would be appropriate.
• Is the entity subject to bonding requirements? Most bonding companies will only accept GAAP financial statements.

Basic Financial Statements

.05 In an OCBOA presentation, the basic financial statements typically present financial position and results of operations as measured under the OCBOA, descriptions of accounting policies, and notes to the financial statements. However, an exception to this presentation exists for entities that use the pure cash basis of accounting. Under the pure cash basis of accounting, a statement of assets, liabilities, and equity would not be prepared because the cash balance would be the only item that would appear. Consequently, entities using the pure cash basis of accounting present a single statement titled “Statement of Cash Receipts and Disbursements.”

Statement Titles

.06 Titles of OCBOA financial statements differ from titles of similar statements prepared in accordance with GAAP. The following table lists some suggested titles for OCBOA financial statements.

<table>
<thead>
<tr>
<th>Generally Accepted Accounting Principles</th>
<th>Cash Basis</th>
<th>Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance Sheet</td>
<td>Statement of Assets, Liabilities, and Equity—Cash Basis</td>
<td>Statement of Assets, Liabilities, and Equity—Income Tax Basis</td>
</tr>
<tr>
<td>Statement of Income</td>
<td>Statement of Revenues and Expenses—Cash Basis</td>
<td>Statement of Revenues and Expenses—Income Tax Basis</td>
</tr>
<tr>
<td>Statement of Income &amp; Retained Earnings</td>
<td>Statement of Revenues, Expenses, and Retained Earnings—Cash Basis</td>
<td>Statement of Revenues, Expenses, and Retained Earnings—Income Tax Basis</td>
</tr>
</tbody>
</table>
Generally Accepted Accounting Principles

<table>
<thead>
<tr>
<th></th>
<th>Cash Basis</th>
<th>Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement of Changes in Equity</td>
<td>Statement of Changes in Equity—Cash Basis</td>
<td>Statement of Changes in Equity—Income Tax Basis</td>
</tr>
</tbody>
</table>

Notes:

- These titles are only suggestions.
- The pure cash basis has a single asset and no liabilities. Accordingly, only a single statement titled "Statement of Cash Receipts and Disbursements" is normally presented.
- Although Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 230, Statement of Cash Flows, does not require a statement of cash flows for OCBOA financial statements, if a cash flow statement is presented, it is suggested that the basis of accounting used be added to the statement title.

Disclosures

.07 Authoritative accounting literature does not address OCBOA or the disclosures necessary in such presentations. However, disclosures should be included in OCBOA financial statements that are similar to those that would be included in a GAAP presentation. As a best practice, cash, modified cash, and income tax basis financial statements ordinarily should be informative of matters that may affect their use, understanding, and interpretation. For example:

- The financial statements could include a brief summary of significant accounting policies that discusses the basis of presentation and describes how the basis differs from GAAP.
- When financial statements contain items the same as, or similar to, those in GAAP financial statements, similar disclosures may be appropriate (for example, depreciation or long-term debt).
- The entity may also consider disclosing matters not specifically identified on the face of the statements, such as related party transactions, restrictions on assets and owners' equity, subsequent events, and uncertainties.
- If GAAP sets forth requirements that apply to the presentation of financial statements, cash, modified cash, and income tax basis statements ordinarily should either comply with those requirements or provide information that communicates the substance of those requirements.

Cash Basis of Accounting

Pure Cash Basis

.08 Under the cash receipts and disbursements basis of accounting (pure cash basis), only transactions that increase or decrease cash and cash equivalents are reflected in the financial statement. The pure cash basis recognizes all cash disbursements as expenses and all cash receipts as revenues. In practice, the pure cash basis of accounting is rare.

.09 Entities that use the pure cash basis of accounting would include, for example, school activity funds, civic ventures, trusts and estates, political action committees and political campaigns. Typically, those types of entities have the following characteristics:

- They are not-for-profit entities.
- Their operations are simple.
- Their accounting and finance functions are unsophisticated.
• There is only one major activity.
• Capital expenditures and long-term debt are not significant.

Modified Cash Basis

.10 The modified cash basis of accounting is described as the pure cash basis incorporating modifications having substantial support. These modifications generally include the recognition of certain transactions having substantial support, such as recording depreciation on fixed assets or accruing income taxes, as entities would recognize them under GAAP. The appropriate modifications and the extent of those modifications are not clearly defined in the literature, however.

.11 Generally, entities that use the modified cash basis of accounting, such as professional association of doctors, lawyers, or CPAs, might include the following characteristics:

• They are for-profit entities.
• They distribute profits as collected (for example, through bonuses and retirement plan contributions).
• They have significant inventory and credit arrangements with vendors.
• They make material capital expenditures or incur material amounts of debt.
• Their operations are somewhat sophisticated, and accounting, for them, may become complex.

Income Tax Basis of Accounting

.12 The income tax basis of accounting typically is based on federal income tax laws that generally do not address financial statement presentation or disclosure considerations, however.

.13 Typically, entities that use the tax basis of accounting are one of the following:

• For-profit enterprises (such as small, closely held companies for which conversion to GAAP would be costly)
• Partnerships whose partnership agreements require the use of the tax basis of accounting
• Not-for-profit organizations seeking relief from the requirements of FASB ASC 720-25 and FASB ASC 958, Not-for-Profit Entities.

Nontaxed Entities

.14 The income tax basis of accounting is defined as the basis an entity uses or expects to use to file its income tax return. There is not any additional guidance on what is meant by the phrase income tax return. If taken literally, nontaxed-entities would not be able to use the income tax basis. However, many practitioners believe that not-for-profit organizations using the accounting principles followed in filing Form 990 may issue income tax basis financial statements.

Other Bases of Accounting

.15 Although less common, entities may present their financial statements on a basis of accounting other than cash, tax, or GAAP. For example, insurance companies present financial statements on a regulatory basis. In addition, entities generally may use other comprehensive bases if they have substantial support and are applied consistently to all items in the financial statements.

Disclosure of Basis of Accounting

.16 AR section 100 states that when the accountant reports on compiled financial statements that omit substantially all disclosures, he or she should disclose the basis of accounting in the compilation report if it is not disclosed in the financial statements.
Other Disclosures

.17 Financial statements prepared on an OCBOA require notes and other disclosures. If the statements are compiled, management may elect to omit substantially all disclosures. However, this option is not available if the statements are reviewed.

Reporting

.18 In general, the only report modification necessary when financial statements are prepared using a comprehensive basis of accounting other than GAAP is the identification of the financial statements. Because financial statements prepared using an OCBOA contain modified titles (for example, “Statement of Assets, Liabilities, and Equity—Income Tax Basis” instead of “Balance Sheet”), the compilation or review report should refer to the modified titles actually used on the statements (for example, “We have compiled the accompanying statement of assets, liabilities, and equity—income tax basis.”). However, when the accountant compiles OCBOA financial statements that omit substantially all disclosures, paragraph .20 of AR section 100 states that the basis of accounting should be disclosed. This disclosure may be in a note to the financial statements. If disclosure is not made as part of the financial statements, the basis should be disclosed in the accountant’s report.

.19 When financial statements that the accountant has compiled omit substantially all disclosures with no reference to basis, but are otherwise in conformity with an OCBOA, the following paragraph may be added to the standard report. For illustrative purposes, the example is of a compilation of income tax basis financial statements.

Management has elected to omit substantially all disclosures ordinarily included in financial statements prepared on the income tax basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the company’s assets, liabilities, equity, revenue, and expenses. Accordingly, these financial statements are not designed for those who are not informed about such matters.

Prescribed Forms

Background

.20 AR section 300, Compilation Reports on Financial Statements Included in Certain Prescribed Forms (AICPA, Professional Standards, vol. 2), provides for an alternative form of standard compilation report when the prescribed form or related instructions call for departures from GAAP.

Provisions of AR Section 300

.21 Any standard, preprinted form designed or adopted by the body to which it is to be submitted is a prescribed form. Examples include forms used by industry trade associations, credit agencies, banks, and governmental and regulatory bodies other than those concerned with the sale or trading of securities.

.22 According to paragraph .03 of AR section 300, the following alternative form of compilation report is appropriate when the financial statements are included in a prescribed form that calls for a departure from GAAP:

I (We) have compiled the (identification of financial statements, including period covered and name of entity) included in the accompanying prescribed form in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

My (Our) compilation was limited to presenting in the form prescribed by (name of body) information that is the representation of management (the owners). I (We) have not audited or reviewed the financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them.
These financial statements (including related disclosures) are presented in accordance with the requirements of (name of body), which differ from generally accepted accounting principles. Accordingly, these financial statements are not designed for those who are not informed about such differences.

.23 Note that the first two paragraphs are similar to the standard compilation report of AR section 100. The main differences are the references to the following:

- The prescribed form
- The body that prescribed the form
- The third paragraph, which indicates that the basis of accounting and disclosures required by the form are different from GAAP and cautions the reader about the limits of the financial statements.

Departures From GAAP or From the Prescribed Form

.24 The accountant is concerned with the following three types of departures in an engagement to compile financial statements to be included in a prescribed form:

- Departures from GAAP required by the prescribed form. This type of departure does not require disclosure in the AR section 300 report.
- Departures from GAAP not required by the prescribed form. Such departures should be disclosed following the guidance in AR section 100.
- Departures from the requirements of the prescribed form. These departures also should be disclosed following the guidance in AR section 100.

.25 For the items in the second and third bullets in the preceding paragraph, the accountant should modify the compilation report to identify, in a separate paragraph, the departures, including the effects, if known. If not known, the accountant should include a statement that the effects have not been determined.

Signing a Preprinted Report Form

.26 Paragraph .05 of AR section 300 states that the accountant should not sign a preprinted report form unless the language in it conforms to the guidance in AR section 300 or AR section 100. If the preprinted report is not suitable, the accountant should attach an appropriate report to the prescribed form and type “See Accountant’s Report” in the prescribed form signature block.

Determining When AR Section 300 Is Applicable

.27 Questions involving the applicability of AR section 300 might pertain to the definition of a prescribed form, the type of service involved or clarification of how a form calls for a departure from GAAP. These issues are discussed in the following questions.

.28 Does AR section 300 establish different standards for compiling a prescribed form? No. The reporting standards of AR section 100 require issuing a report whenever the accountant compiles or reviews financial statements included in a prescribed form. AR section 300 merely provides an alternative form of standard compilation report. It does not expand the accountant’s reporting responsibility, nor does it change the performance standards of AR section 100.

.29 Is AR section 300 applicable to review engagements? No. AR section 300 makes no provision for an alternative review report. A review report should conform to the standards of AR section 100 or AR section 200. The report should describe any departures from GAAP (even if the departures are called for by the form). The review report should also describe each GAAP disclosure that is omitted.

.30 Is a tax return a prescribed form? No. AR section 300 refers to financial statements, and thus excludes financial presentations included in tax returns. Interpretation No. 10, “Reporting on Tax Returns,” of AR section 100 (AICPA, Professional Standards, vol. 2, AR sec. 9100 par. .31–.32) points out that an accountant may
attach a report to tax or information returns. This report should follow the guidance in AR section 100 because the tax return will be submitted to a user that did not design the form.

.31 Does a comprehensive set of instructions constitute a prescribed form? No. The definition of a prescribed form in AR section 300 specifically includes the words standard preprinted form.

.32 Is AR section 300 applicable to a prescribed form that does not call for departures from GAAP? No. If the form does not call for departures from GAAP, the AR section 300 alternative report is not appropriate.

.33 How does a prescribed form call for departures from GAAP? AR section 300 indicates that a form calls for a departure from GAAP by either:
   • specifying a measurement principle not in conformity with GAAP; or
   • failing to request disclosures required by GAAP.

.34 Can an AR section 100 report be issued even if AR section 300 applies? Yes. The accountant should, however, comply with AR section 100 regarding departures from GAAP.

.35 Is the AR section 300 report appropriate when a prescribed form is presented to other third parties? No. The AR section 300 alternative report presumes that the information required by a prescribed form is sufficient to meet the needs of the body that designed or adopted the form.

.36 What does an accountant do when financial statements presented on an OCBOA are included in the prescribed form and uses, for example, the terms Balance Sheet or Income Statement? In practice, the titles usually are not changed, and the report on the statements use the preprinted titles.

.37 What if the accountant is not independent? An accountant who is not independent can issue an AR section 300 report on financial statements included in a prescribed form. He or she should, however, comply with AR section 100 and include the following as the last paragraph of the report:

   I am (We are) not independent with respect to XYZ Company.

.38 Should each page of the prescribed form be marked with “See Accountant’s Report”? Yes. AR section 300 does not change that requirement.

Personal Financial Statements

.39 The term personal financial statements refers to financial statements that present the personal assets and liabilities of an individual or group of related individuals.

.40 AICPA Statement of Position (SOP) 82-1, Accounting and Financial Reporting for Personal Financial Statements (AICPA, Technical Practice Aids, ACC sec. 10,350), is the principle source of guidance in dealing with personal financial statements. This SOP establishes the current value basis of accounting as GAAP for personal financial statements. The AICPA Audit Guide Personal Financial Statements contains guidance on the scope of work and form of report for audits, reviews, and compilations of personal financial statements.

Personal Financial Statements Engagements

.41 Using the estimated current value basis of accounting in personal financial statements creates some unique considerations for accountants engaged to compile or review such statements.

Acceptance of Clients

.42 Before accepting the engagement, the accountant typically considers his or her independence, the client’s integrity, and circumstances that present unusual business risks.
Personal financial statement engagements usually require a greater degree of client participation than do other engagements. In many cases, client interviews and telephone inquiries are an integral part of the process. Therefore, it is especially important to consider a potential client’s ability and willingness to provide sufficient data and reliable estimates of current value.

Engagement Letters

Both AR section 100 and the Audit Guide *Personal Financial Statements* recommend, but do not require, written engagement letters. Engagement letters are especially important in personal financial statement engagements to

- dispel any notion that the accountant is responsible for estimates of current value.
- link the client’s cooperation to the fee because the cooperation of the client is vital to developing adequate accounting information.

Client Representation Letters

Although AR section 100 only requires that a representation letter be obtained from the client in engagements to review personal financial statements, the Audit Guide *Personal Financial Statements* recommends obtaining written representations on all personal financial statement engagements because of the following:

- The informal nature of personal financial records usually requires that accountants place greater reliance on the client’s representation to ensure completeness of the statements.
- The estimated current values and amounts of assets and liabilities provided by the client have a significant effect on the statements.
- A client representation letter can help to clarify that responsibility for the estimates of current value, even if developed by the accountant, rests with the client.

Compilation of Personal Financial Statements

Standards for compilation of financial statements prescribed by AR section 100 are applicable to the compilation of personal financial statements in the same manner as to the compilation of other financial statements. There is an exception for personal financial statements contained in written financial plans, if certain criteria are met (see the subsequent heading in this section of the manual, “Exception for Personal Financial Statements Included in Written Financial Plans”).

First, the accountant should have knowledge of the accounting principles and practices applicable to personal financial statements. For instance, the accountant should understand the provisions of SOP 82-1.

Second, the accountant ordinarily should possess a general understanding of the following:

- The nature of the individual’s transactions
- The form of available accounting records
- The stated qualifications of accounting personnel, if any
- The basis of accounting on which the financial statements are to be presented
- The form and content of the financial statements
- The methods used for determining estimated current values of significant assets and estimated current amounts of significant liabilities, and be able to consider whether the methods are appropriate in light of the nature of each asset or liability

Third, the accountant should read the financial statements and consider whether they appear to be appropriate in form and free of obvious material errors.
The standards prescribed by SSARSs do not require an accountant to verify the reasonableness of information supplied to him or her in a compilation engagement. Accordingly, he or she can compile personal financial statements based on the client’s estimate of current values and amounts.

However, the Audit Guide *Personal Financial Statements* warns that other factors may prevent the acceptance of the client’s estimate. The guide states that, at a minimum, the accountant should obtain an understanding of the methods by which the individual determined the estimated current values and amounts and consider whether the methods are appropriate for the asset or liability.

With the exception of compiled personal financial statements that omit substantially all disclosures, the financial statements, including the notes, ordinarily should disclose the method used to determine the estimated current values and amounts, even when such values or amounts are based on the individual’s estimate.

In many situations, particularly when the individual is unsophisticated in financial matters, the accountant will assist the client in developing the estimated current values and amounts. In such situations, the accountant ordinarily should obtain the individual’s approval and acceptance of responsibility for the values, preferably in writing.

**Review of Personal Financial Statements**

Standards for the review of financial statements prescribed by AR section 100 are applicable to the review of personal financial statements in the same manner as the review of other financial statements. Accordingly, to review personal financial statements, the accountant should meet the following general requirements.

The accountant should possess *(a)* a level of knowledge of the accounting principles and practices applicable to personal financial statements and *(b)* an understanding of the individual’s financial activities and financial position that will provide him, through the performance of inquiry and analytical procedures, with a reasonable basis for expressing limited assurance that no material modifications are necessary to the financial statements for them to conform to GAAP. Knowledge of accounting principles and practices implies that the accountant should be thoroughly familiar with the requirements of SOP 82-1.

AR section 100 requires accountants to obtain a representation letter in all review engagements.

**Reporting**

In general, the only report modifications necessary when presenting personal financial statements are the identification of the financial statements and identification of the reporting entity. For example:

I (we) have compiled the accompanying statement of financial condition of James and Jane Person as of December 31, 20XX, and the related statement of changes in net worth for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of the individuals whose financial statements are presented. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

However, when the accountant compiles personal financial statements that omit substantially all disclosures, the Audit Guide *Personal Financial Statements* indicates that he or she disclose that assets are presented at their estimated current values, and liabilities are presented at their estimated current amount. This disclosure may be in a note to the financial statements. If disclosure is not made as part of the financial statements, modification of the compilation report would be required. For example, the following sentence could be added to the first paragraph of the standard compilation report:
The financial statement(s) is (are) intended to present the assets of James and Jane Person at estimated current values and their liabilities at estimated current amounts.

.59 In addition, if substantially all disclosures have been omitted, the accountant should communicate this fact in the compilation report, by adding the following paragraph:

The individuals whose financial statements are presented have elected to omit substantially all disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the individuals’ assets, liabilities, and net worth. Accordingly, these financial statements are not designed for those who are not informed about such matters.

Exception for Personal Financial Statements Included in Written Financial Plans

.60 Paragraph .03 of AR section 600, Reporting on Personal Financial Statements Included in Written Personal Financial Plans (AICPA, Professional Standards, vol. 2), provides an exemption from AR section 100 for personal financial statements included in written personal financial plans when the following conditions exist:

- The accountant establishes an understanding with the client, preferably in writing, that the financial statements (1) will be used solely to assist the client and the client’s advisers to develop the client’s personal financial goals and objectives and (2) will not be used to obtain credit or for any purpose other than developing the financial plan.
- Nothing comes to the accountant’s attention during the engagement that would cause him to believe that the financial statements will be used to obtain credit or for any purpose other than developing the client’s financial goals and objectives.

.61 If both conditions exist, the accountant is exempt from both the performance and reporting standards in AR section 100. Absent both of these conditions, AR section 100 would apply.

.62 As long as those same conditions are met, Interpretation No. 1, “Submitting a Personal Financial Plan to a Client’s Advisers,” of AR section 600 (AICPA, Professional Standards, vol. 2, AR sec. 9600 par. .01–.03) clarifies that the same exception applies when an accountant submits a written personal financial plan containing the financial statements for use by a client’s advisers to help the client implement the personal financial plan. Implementing the plan includes, for example, use of the plan by an insurance broker who will recommend specific insurance products to the client, an investment adviser who will provide specific recommendations about the investment portfolio, and an attorney who will draft a will or trust document.

The Accountant’s Report

.63 AR section 600 prescribes the following language when the conditions of the AR section 100 exemption are met:

The accompanying statement of financial condition of John Doe, as of December 31, 20XX, was prepared solely to help you develop your personal financial plan. Accordingly, it may be incomplete or contain departures from generally accepted accounting principles and should not be used to obtain credit or for any other purposes other than developing your personal financial plan. We have not audited, reviewed, or compiled the statement.

.64 AR section 600 does not require the accountant to identify specific measurement or disclosure departures in the report. A notation such as “See Accountant’s Report” should be included on each financial statement page.
Specified Elements, Accounts, or Items of a Financial Statement

.65 A compilation of one or more specified elements, accounts, or items of a financial statement is limited to presenting financial information that is the representation of management (owners) without undertaking to express any assurance on that information. (The accountant might consider it necessary to perform other accounting services to compile the financial information.)

.66 Examples of specified elements, accounts, or items of a financial statement that an accountant may compile include schedules of rentals, royalties, profit participation, or provision for income taxes.

.67 In accordance with paragraph .04 of AR section 110, Compilation of Specified Elements, Accounts, or Items of a Financial Statement (AICPA, Professional Standards, vol. 2), if an accountant prepares or assists a client in preparing a schedule of one or more specified elements, accounts, or items of a financial statement, the accountant should consider how such a presentation of specified elements, accounts, or items will be used. If the specified element, account, or item of a financial statement is included as accompanying information to the basic financial statements, the accountant should consider the guidance in paragraph .83 of AR section 100. The accountant should also consider the potential of being associated with the schedule and the likelihood that the user may inappropriately infer, through that association, an unintended level of assurance. If the accountant believes that he or she will be associated with the information, the accountant should consider issuing a compilation report so a user will not infer a level of assurance that does not exist.

.68 An engagement to compile one or more specified elements, accounts, or items of a financial statement may be undertaken as a separate engagement or in conjunction with a compilation of financial statements.

.69 Before issuance of a compilation report on one or more specified elements, accounts, or items of a financial statement, the accountant should read such compiled specified elements, accounts, or items of a financial statement and consider whether the information appears to be appropriate in form and free of obvious material errors. In this context, the term error refers to mistakes in the compilation of the specified elements, accounts, or items of a financial statement, including arithmetical or clerical mistakes, and mistakes in the application of accounting principles, including disclosures, if presented.

.70 When the accountant is engaged to compile or issues a compilation report on one or more specified elements, accounts, or items of a financial statement, the basic elements of the report, in addition to the basic elements described in paragraph .05 of section 2600 of this manual are as follows:

a. A statement that the specified element(s), account(s), or item(s) identified in the report were compiled. If the compilation was performed in conjunction with a compilation of the company’s financial statements, the paragraph should so state and indicate the date of the accountant’s compilation report on those financial statements. Furthermore, any departure from the standard report on those statements should also be disclosed if considered relevant to the presentation of the specified element(s), account(s), or item(s).

b. A description of the basis on which the specified element(s), account(s), or item(s) are presented if that basis is not generally accepted accounting principles and a statement that that basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles.

.71 Each page of the compiled specified elements, accounts, or items of a financial statement should include a reference, such as “See Accountant’s Compilation Report.”

.72 Following are illustrations of accountant’s compilation reports on specified elements, accounts, or items of a financial statement.

Report Related to Accounts Receivable

I (we) have compiled the accompanying schedule of accounts receivable of XYZ Company as of December 31, 20X6, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.
A compilation is limited to presenting financial information that is the representation of management (owners). I (we) have not audited or reviewed the accompanying schedule of accounts receivable and, accordingly, do not express an opinion or any other form of assurance on it.

Report Related to the Schedule of Depreciation—Income Tax Basis

I (we) have compiled the accompanying schedule of depreciation—income tax basis of XYZ Company as of December 31, 20X6, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA. The schedule of depreciation—income tax basis has been prepared on the accounting basis used by the company for federal income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

A compilation is limited to presenting financial information that is the representation of management (owners). I (we) have not audited or reviewed the accompanying schedule of depreciation—income tax basis and, accordingly, do not express an opinion or any other form of assurance on it.

Relationship of Statements on Standards for Accounting and Review Services to Quality Control Standards

.73 Paragraphs .93–.95 of AR section 100 states that an accountant is responsible for compliance with SSARSs in a review or compilation engagement. Rule 202, Compliance With Standards (AICPA, Professional Standards, vol. 2, ET sec. 202 par. .01), of the AICPA Code of Professional Conduct requires members to comply with such standards when associated with reviewed or compiled financial statements.

.74 An accountant has the responsibility to adopt a system of quality control in conducting an accounting practice. Thus, a firm should establish quality control policies and procedures to provide it with reasonable assurance that its personnel comply with SSARSs in its review and compilation 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.

.75 SSARSs relate to the conduct on individual review and compilation engagements; Statements on Quality Control Standards (SQCSs) relate to the conduct of a firm’s accounting practice. Thus, SSARSs and SQCSs are related, and the quality control policies and procedures that a firm adopts may affect both the conduct of an individual engagement and the firm’s accounting practice as a whole. However, deficiencies in or instances of noncompliance with a firm’s quality control policies and procedures do not, in and of themselves, indicate that a particular review or compilation engagement was not performed in accordance with SSARSs.

[The next page is 2701.]
AAM Section 2710

Accountants’ Reports on Prescribed Forms, Specified Elements, Personal Financial Statements, and OCBOA Financial Statements *

.01 Compilation Report—Cash Basis Statements; Full Disclosure

Stockholders and Board of Directors
[Company]

I (We) have compiled the accompanying statement of assets, liabilities, and equity—modified cash basis of [Company] as of December 31, 20X6, and the related statement of revenues and expenses—modified cash basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

January 28, 20X7

[Signature of CPA]

[Source: Derived from paragraph .16 of AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2)]

* In February 2009, the Accounting and Review Services Committee issued Statement on Standards for Accounting and Review Services (SSARS) No. 18, Applicability of Statements on Standards for Accounting and Review Services (AICPA, Professional Standards, vol. 2), which amends paragraph .01 of AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2). SSARS No. 18 revises the applicability of the SSARSs so that SSARSs do not apply when the provisions of AU section 722, Interim Financial Information (AICPA, Professional Standards, vol. 1), apply. SSARS No. 18 is effective for compilations and reviews of financial statements for periods beginning after December 15, 2009, with early application permitted. This manual will be updated for SSARS No. 18 in the next edition.
.02 Compilation Report—Cash Basis Statements; Omission of Substantially All Disclosures, Including Disclosure of Basis

Stockholders and Board of Directors

[Company]

[Address]

I (We) have compiled the accompanying statement of assets, liabilities, and equity—modified cash basis of [Company] as of December 31, 20X6, and the related statement of revenues and expenses—modified cash basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA. The financial statements have been prepared on the modified cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

Management has elected to omit substantially all disclosures ordinarily included in financial statements prepared on the modified cash basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the Company’s assets, liabilities, equity, revenue, and expenses. Accordingly, these financial statements are not designed for those who are not informed about such matters.

January 28, 20X7

[Signature of CPA]

[Source: Derived from paragraph .22 of AR section 100]

.03 Compilation Report—Tax Basis Statements; Full Disclosure

Stockholders and Board of Directors

[Company]

[Address]

I (We) have compiled the accompanying statement of assets, liabilities, and equity—income tax basis of [Company] as of December 31, 20X6, and the related statement of revenues and expenses—income tax basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

January 28, 20X7

[Signature of CPA]

[Source: Derived from paragraph .16 of AR section 100]
.04 Compilation Report—Tax Basis Statements; Omission of Substantially All Disclosures, Including Disclosure of Basis

Stockholders and Board of Directors
[Company]
[Address]

I (We) have compiled the accompanying statement of assets, liabilities, and equity—income tax basis of [Company] as of December 31, 20X6, and the related statement of revenues and expenses—income tax basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA. The financial statements have been prepared on the accounting basis used by the company for federal income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

Management has elected to omit substantially all disclosures ordinarily included in financial statements prepared on the income tax basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the Company’s assets, liabilities, equity, revenue, and expenses. Accordingly, these financial statements are not designed for those who are not informed about such matters.

January 28, 20X7
[Signature of CPA]

[Source: Derived from paragraph .22 of AR section 100]

.05 Review Report—Cash Basis Statements; Full Disclosure

Stockholders and Board of Directors
[Company]
[Address]

I (We) have reviewed the accompanying statement of assets, liabilities, and equity—cash basis of [Company] as of December 31, 20X6, and the related statement of cash receipts and disbursements for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA. All information included in these financial statements is the representation of the management (owners) of [Company].

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with the cash basis of accounting, as described in Note [Number].

January 28, 20X7
[Signature of CPA]

[Source: Derived from paragraph .50 of AR section 100]
.06 Review Report—Tax Basis Statements; Full Disclosure

Stockholders and Board of Directors

[Company]

[Address]

I (We) have reviewed the accompanying statement of assets, liabilities, and equity—income tax basis of
[Company] as of December 31, 20X6, and the related statement of revenues and expenses—income tax basis
for the year then ended, in accordance with Statements on Standards for Accounting and Review Services
issued by the AICPA. All information included in these financial statements is the representation of the
management (owners) of [Company].

A review consists principally of inquiries of company personnel and analytical procedures applied to financial
data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards,
the objective of which is the expression of an opinion regarding the financial statements taken as a whole.
Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the
accompanying financial statements in order for them to be in conformity with the income tax basis of
accounting, as described in Note [Number].

January 28, 20X7

[Signature of CPA]

[Source: Derived from paragraph .50 of AR section 100]

.07 Financial Statements Included in Certain Prescribed Forms

[Name], President

[Company]

[Address]

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20X6, and the related
statements of income, retained earnings, and cash flows for the year then ended included in the accompanying
prescribed form in accordance with Statements on Standards for Accounting and Review Services issued by
the AICPA.

My (our) compilation was limited to presenting in the form prescribed by the [Name of Bank or Other Entity]
information that is the representation of management (owners). I (We) have not audited or reviewed the
financial statements referred to above and, accordingly, do not express an opinion or any other form of
assurance on them.

These financial statements (including related disclosures) are presented in accordance with the requirements
of the [Name of Bank or Other Entity], which differ from generally accepted accounting principles. Accordingly,
these financial statements are not designed for those who are not informed about such differences.

January 28, 20X7

[Signature of CPA]

[Source: Derived from paragraph .03 of AR section 300, Compilation Reports on Financial Statement Included in
Certain Prescribed Forms (AICPA, Professional Standards, vol. 2)]
.08 Financial Statements Included in Certain Prescribed Forms—Departure From GAAP Not Called for by the Prescribed Form

[Name], President
[Company]
[Address]

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20X6, and the related statements of income, retained earnings, and cash flows for the year then ended included in the accompanying prescribed form in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

My (our) compilation was limited to presenting in the form prescribed by the [Name of Bank or Other Entity] information that is the representation of management (owners) . I (We) have not audited or reviewed the financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them. However, I (we) did become aware of a departure from generally accepted accounting principles that is not called for by the form or related instructions prescribed by the [Name of Bank or Other Entity] that is described in the following paragraph.

The instructions that accompany the prescribed form require that [describe requirement]. Management has (Owners have) informed us that the company [describe deviation]. Management has (Owners have) not determined the effect of the departure on the accompanying financial statements.

These financial statements (including related disclosures) are presented in accordance with the requirements of the [Name of Bank or Other Entity], which differ from generally accepted accounting principles. Accordingly, these financial statements are not designed for those who are not informed about such differences.

January 28, 20X7

[Signature of CPA]

[Source: Derived from paragraph .04 of AR section 300]

.09 Compilation Report—Personal Financial Statements; GAAP Basis

[Name]
[Address]

I (we) have compiled the accompanying statement of financial condition of James and Jane Person as of December 31, 20X6, and the related statement of changes in net worth for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of the individuals whose financial statements are presented. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

January 28, 20X7

[Signature of CPA]

[Source: Derived from paragraph .16 of AR section 100]
.10 Compilation Report—Personal Financial Statements; GAAP Basis With GAAP Departure for Omission of Provision for Income Taxes

[Name]
[Address]

I (we) have compiled the accompanying statement of financial condition of James and Jane Person as of December 31, 20X6, in accordance with Statements on Standards for Accounting and Review Services issued by the AICPA.

A compilation is limited to presenting in the form of financial statements information that is the representation of the individuals whose financial statements are presented. I (we) have not audited or reviewed the accompanying statement of financial condition and, accordingly, do not express an opinion or any other form of assurance on it. However, I (we) did become aware of a departure from generally accepted accounting principles that is described in the following paragraph.

As disclosed in Note X to the statement of financial condition, generally accepted accounting principles require that personal financial statements include a provision for estimated income taxes on the differences between the estimated current values of assets and estimated current amounts of liabilities and their tax bases. The accompanying statement of financial condition does not include such a provision and the effect of this departure from generally accepted accounting principles has not been determined.

January 28, 20X7

[Signature of CPA]

[Source: Derived from paragraph .57 of AR section 100]

[The next page is 3001.]
Sections 3160 and 3165 include illustrative audit assignment control forms and engagement letters that can be used by an accountant in the planning phase of an audit engagement.

Various formats of audit assignment controls and engagement letters are in use; nevertheless, inclusion of the formats in this section in no way means that they are preferable. Refer directly to authoritative pronouncements when appropriate.

Illustrative formats of audit assignment controls and engagement letters are often helpful in developing a consistent style within a firm. However, no set of illustrative formats can cover all the situations that are likely to be encountered in practice because the circumstances of engagements vary widely.

Readers should consider other sources of illustrative presentations, such as those in authoritative pronouncements and AICPA Audit and Accounting Guides.

**References to Professional Standards**. When referring to the professional standards, this manual cites the applicable sections as codified in the AICPA Professional Standards and not the numbered statements, as appropriate. For example, Statement on Auditing Standards No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of the AICPA Professional Standards. All references to AU sections may be found in AICPA Professional Standards, volume 1.

### TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>3100</td>
<td>Planning the Engagement</td>
<td>.01-.37</td>
</tr>
<tr>
<td></td>
<td>General</td>
<td>.01-.05</td>
</tr>
<tr>
<td></td>
<td>Audit Planning</td>
<td>.06-.37</td>
</tr>
<tr>
<td></td>
<td>Appointment of the Independent Auditor</td>
<td>.07</td>
</tr>
<tr>
<td></td>
<td>Establishing an Understanding With the Client and Preparing an Engagement Letter</td>
<td>.08-.29</td>
</tr>
<tr>
<td></td>
<td>Preliminary Engagement Activities</td>
<td>.30</td>
</tr>
<tr>
<td></td>
<td>The Overall Audit Strategy</td>
<td>.31</td>
</tr>
<tr>
<td></td>
<td>The Audit Plan</td>
<td>.32</td>
</tr>
<tr>
<td></td>
<td>Determining the Extent of Involvement of Professionals Possessing Specialized Skills</td>
<td>.33-.35</td>
</tr>
<tr>
<td></td>
<td>Communications With Those Charged With Governance and Management</td>
<td>.36</td>
</tr>
<tr>
<td></td>
<td>Additional Considerations in Initial Audit Engagements</td>
<td>.37</td>
</tr>
<tr>
<td>3105</td>
<td>Understanding the Assignment</td>
<td>.01-.13</td>
</tr>
<tr>
<td></td>
<td>Generally Accepted Auditing Standards</td>
<td>.05-.13</td>
</tr>
<tr>
<td>3110</td>
<td>Assigning Personnel to the Engagement and Supervision</td>
<td>.01-.13</td>
</tr>
<tr>
<td></td>
<td>General Comments</td>
<td>.01-.02</td>
</tr>
<tr>
<td></td>
<td>Engagement Planning Procedures</td>
<td>.03-.08</td>
</tr>
<tr>
<td></td>
<td>Supervision</td>
<td>.09-.13</td>
</tr>
</tbody>
</table>
### Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>3115 Independence</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>General Comments</td>
<td>.01-07</td>
</tr>
<tr>
<td></td>
<td>Maintaining Your Independence</td>
<td>.08-45</td>
</tr>
<tr>
<td></td>
<td>Covered Member</td>
<td>.10-11</td>
</tr>
<tr>
<td></td>
<td>Family Members</td>
<td>.12-19</td>
</tr>
<tr>
<td></td>
<td>Financial Relationships</td>
<td>.20-26</td>
</tr>
<tr>
<td></td>
<td>Business Relationships</td>
<td>.27-30</td>
</tr>
<tr>
<td></td>
<td>Unpaid Fees</td>
<td>.31</td>
</tr>
<tr>
<td></td>
<td>Restricted Entities</td>
<td>.32-34</td>
</tr>
<tr>
<td></td>
<td>Nonattest Services</td>
<td>.35-45</td>
</tr>
<tr>
<td></td>
<td>Independence Quality Controls</td>
<td>.46-51</td>
</tr>
<tr>
<td></td>
<td>Additional Guidance</td>
<td>.52-54</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Section</th>
<th>3120 Understanding the Entity and Its Environment</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>General</td>
<td>.01-30</td>
</tr>
<tr>
<td></td>
<td>Risk Assessment Procedures</td>
<td>.01-03</td>
</tr>
<tr>
<td></td>
<td>Inquiry of Management and Others</td>
<td>.04-14</td>
</tr>
<tr>
<td></td>
<td>Examples of Inquiries of Others Within the Entity</td>
<td>.07</td>
</tr>
<tr>
<td></td>
<td>Analytical Procedures</td>
<td>.08</td>
</tr>
<tr>
<td></td>
<td>Observations and Inspection of Documents</td>
<td>.09-11</td>
</tr>
<tr>
<td></td>
<td>A Mix of Procedures</td>
<td>.12-13</td>
</tr>
<tr>
<td></td>
<td>Discussion Among the Audit Team</td>
<td>.14</td>
</tr>
<tr>
<td></td>
<td>Understanding Specified Aspects of the Entity and Its Environment</td>
<td>.15-19</td>
</tr>
<tr>
<td></td>
<td>Industry, Regulatory, and Other External Factors</td>
<td>.20-29</td>
</tr>
<tr>
<td></td>
<td>Nature of the Entity</td>
<td>.21-22</td>
</tr>
<tr>
<td></td>
<td>Objectives and Strategies and Related Business Risks</td>
<td>.23-24</td>
</tr>
<tr>
<td></td>
<td>Measurement and Review of the Entity’s Financial Performance</td>
<td>.25-26</td>
</tr>
<tr>
<td></td>
<td>Internal Control</td>
<td>.27-28</td>
</tr>
<tr>
<td></td>
<td>Documentation</td>
<td>.29</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Section</th>
<th>3125 Understanding of Internal Control</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Introduction</td>
<td>.01-32</td>
</tr>
<tr>
<td></td>
<td>What Auditors Should Understand About Internal Control</td>
<td>.01-05</td>
</tr>
<tr>
<td></td>
<td>How an Auditor Obtains an Understanding of Internal Control</td>
<td>.06-24</td>
</tr>
<tr>
<td></td>
<td>Documenting the Understanding</td>
<td>.25-31</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Section</th>
<th>3130 Assessing the Risks of Material Misstatement</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>General</td>
<td>.01-15</td>
</tr>
<tr>
<td></td>
<td>Financial Statement Assertions</td>
<td>.01-04</td>
</tr>
<tr>
<td></td>
<td>Assessing Risks at the Financial Statement Level</td>
<td>.05-06</td>
</tr>
<tr>
<td></td>
<td>Assessing Risks at the Assertion Level</td>
<td>.07-08</td>
</tr>
<tr>
<td></td>
<td>Significant Risks That Require Special Audit Consideration</td>
<td>.09-11</td>
</tr>
<tr>
<td></td>
<td>Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence</td>
<td>.12</td>
</tr>
<tr>
<td></td>
<td>Revision of Risk Assessment</td>
<td>.13</td>
</tr>
<tr>
<td></td>
<td>Documentation</td>
<td>.14</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Section</th>
<th>3140 Audit Risk and Materiality</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>General</td>
<td>.01-58</td>
</tr>
<tr>
<td></td>
<td>Nature and Causes of Misstatements</td>
<td>.01-02</td>
</tr>
<tr>
<td></td>
<td>Considerations at the Financial Statements Level</td>
<td>.03-07</td>
</tr>
<tr>
<td></td>
<td></td>
<td>.08-12</td>
</tr>
</tbody>
</table>
### Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>3140</td>
<td>Audit Risk and Materiality—continued</td>
</tr>
<tr>
<td>Considerations at the Individual Account Balance, Class of Transactions, or Disclosure Level</td>
<td>.13-.21</td>
</tr>
<tr>
<td>Materiality</td>
<td>.22-.39</td>
</tr>
<tr>
<td>Determining Materiality for the Financial Statements Taken as a Whole When Planning the Audit</td>
<td>.23-.26</td>
</tr>
<tr>
<td>Tolerable Misstatement</td>
<td>.27</td>
</tr>
<tr>
<td>Qualitative Aspects of Materiality</td>
<td>.28-.29</td>
</tr>
<tr>
<td>Considerations as the Audit Progresses</td>
<td>.30-.32</td>
</tr>
<tr>
<td>Quantifying Materiality</td>
<td>.33-.35</td>
</tr>
<tr>
<td>Example</td>
<td>.36-.37</td>
</tr>
<tr>
<td>SEC Staff Bulletin on Materiality for SEC Registrants</td>
<td>.38-.39</td>
</tr>
<tr>
<td>Communication of Misstatements to Management</td>
<td>.40-.42</td>
</tr>
<tr>
<td>Evaluating Audit Findings</td>
<td>.43-.58</td>
</tr>
<tr>
<td>Likely Misstatements</td>
<td>.46-.49</td>
</tr>
<tr>
<td>Known Misstatements</td>
<td>.50</td>
</tr>
<tr>
<td>Misstatements From the Prior Year</td>
<td>.51</td>
</tr>
<tr>
<td>Summarizing and Evaluating Misstatements</td>
<td>.52-.56</td>
</tr>
<tr>
<td>Documentation</td>
<td>.57-.58</td>
</tr>
</tbody>
</table>

| 3145 | Fraud | .01-.32 |
| General | .01-.03 |
| Description and Characteristics of Fraud | .04-.07 |
| Misstatements Arising From Fraudulent Financial Reporting | .06 |
| Misstatements Arising From Misappropriation of Assets | .07 |
| The Importance of Exercising Professional Skepticism | .08 |
| Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud | .09-.10 |
| Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud | .11-.13 |
| Identifying Risks That May Result in a Material Misstatement Due to Fraud | .14-.16 |
| Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity’s Programs and Controls That Address the Risks | .17-.20 |
| Responding to the Results of the Assessments | .18-.19 |
| Overall Responses to the Risk of Material Misstatement | .20 |
| Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed to Address the Identified Risks | .21 |
| Responses to Further Address the Risk of Management Override of Controls | .22 |
| Evaluating Audit Evidence | .23-.27 |
| Communicating About Possible Fraud to Management, Those Charged With Governance, and Others | .28-.30 |
| Documenting the Auditor’s Consideration of Fraud | .31 |
| Fraud Risk Factor Memory Jogger | .32 |

| 3150 | Illegal Acts | .01-.10 |
| General Comments | .01-.02 |
| Direct and Material Effect Illegal Acts | .03-.05 |
| Other Illegal Acts | .06-.07 |
| Engagement Planning Procedures | .08-.10 |

| 3155 | Analytical Procedures | .01-.23 |
3155 Analytical Procedures—continued

General Comments ................................................................. .01-.02
Analytical Procedures .............................................................. .03-.08
Analytical Procedure Process: Four Phases .................................... .09-.17
  Expectation Formation (Phase I) ............................................. .11-.13
  Identification and Investigation (Phases II and III) ...................... .14-.15
  Evaluation (Phase IV) ......................................................... .16-.17
Engagement Planning Procedures ................................................ .18-.20
Audit Documentation Requirements ............................................. .21
Analytical Procedures Audit Guide ............................................. .22-.23

3160 Audit Assignment Controls ................................................ .01-.05

3165 Sample Engagement Letters ................................................. .01-.07

[The next page is 3101.]
AAM Section 3100

Planning the Engagement

General

.01 The planning phase is an important part of every engagement. During this phase, the partner and the staff obtain an understanding of the entity and its environment, including its internal control, then develop an overall strategy for the expected conduct and scope of the engagement.

.02 The need for planning is highlighted in Rule 201, General Standards (AICPA, Professional Standards, vol. 1, ET sec. 201 par. .01), of the AICPA Code of Professional Conduct, which states: “A member shall adequately plan and supervise the performance of professional services.”

.03 The first standard of fieldwork of generally accepted auditing standards (GAAS) states: “The auditor must adequately plan the work and must properly supervise any assistants.” AU section 311, Planning and Supervision (AICPA, Professional Standards, vol. 1), establishes standards and provides guidance to the independent auditor conducting an audit in accordance with GAAS on the considerations and activities applicable to planning and supervision.

.04 Proper planning also enhances the productivity of engagement personnel and may result in a more profitable engagement.

.05 The nature, timing, and extent of planning vary with the size and complexity of the entity and with the auditor’s experience with the entity and understanding of the entity and its environment, including its internal control. The auditor must plan the audit so that it is responsive to the assessment of the risk of material misstatement based on the auditor’s understanding of the entity and its environment, including its internal control (see AAM sections 3120 and 3125).

Audit Planning

.06 Planning is not a discrete phase of the audit, but rather an iterative process that begins with engagement acceptance and continues throughout the audit as the auditor performs audit procedures and accumulates sufficient appropriate audit evidence to support the audit opinion. As a result of performing planned audit procedures, the auditor may obtain disconfirming evidence that might cause the auditor to revise the overall audit strategy.

Appointment of the Independent Auditor

.07 Early appointment of the independent auditor has many advantages to both the auditor and the client. Early appointment enables the auditor to plan the audit prior to the balance-sheet date. Although early appointment is preferable, an independent auditor may accept an engagement near or after the close of the fiscal year. In such instances, before accepting the engagement, the auditor should ascertain whether circumstances are likely to permit an adequate audit and expression of an unqualified opinion and, if they will not, the auditor should discuss with the client the possible necessity for a qualified opinion or disclaimer of opinion.

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1 Paragraph .03 of AU section 314, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (AICPA, Professional Standards, vol. 1), provides guidance with respect to the procedures the auditor performs in obtaining an understanding of the entity and its environment to establish a frame of reference within which the auditor plans the audit and exercises professional judgment about assessing the risks of material misstatement of the financial statements.
Establishing an Understanding With the Client and Preparing an Engagement Letter

.08 The auditor should establish an understanding with the client regarding the services to be performed for each engagement. The understanding should include the objectives of the engagement, management’s responsibilities, the auditor’s responsibilities, and limitations of the engagement. Such an understanding reduces the risk that either the auditor or the client may misinterpret the needs or expectations of the other party. The understanding could also include matters such as the timing of field work, report deadlines, and methods of fee determination and payment.

.09 AU section 311 states that the auditor should document the understanding through a written communication with the client in the form of an engagement letter. An engagement letter helps to prevent misunderstandings between the client and the auditor regarding the services to be provided, including the limitations. The engagement letter also sets forth the responsibilities of the client and, in most states, it becomes a legally binding contract on both parties. There are other good reasons to obtain an engagement letter, including the following:

- Reduce the risk of litigation and avoid misunderstandings with the client. In today’s litigious environment an engagement letter is needed for both old and new clients. To avoid misunderstandings, the engagement letter generally describes in detail the services to be rendered, the fee, and other terms and conditions of the engagement. Oral agreements may result in differences of recollection or understanding between the auditor and the client.
- Avoid misunderstandings by the staff. It is necessary for the members of the staff working on the engagement to have a complete understanding of what is required of them. A copy of the engagement letter in the working papers provides them with an authoritative reference to supplement their oral instructions.

.10 Often, entities that have never been audited resist signing a client representation letter. To avoid client resistance at the end of the audit, many firms notify the client in the engagement letter that they will be asked to sign a client representation letter.

.11 If the auditor has reason to believe the client may publish all or a portion of an audit report, he may advise the client (preferably in the engagement letter) that firm policy is to read printer’s proofs of the report and any other accompanying material. This precaution protects both the client and the auditor against condensation of financial statements, omission of footnotes, erroneous layout, and other errors such as misstatement of figures used in a president’s letter, other narrative, or statistics.

.12 Generally, the auditor establishes the understanding with the client and prepares the engagement letter before any significant work takes place on the engagement. The partner may personally present the letter to the client to ensure that a complete understanding has been achieved. The understanding or a signed copy of the engagement letter may be filed with the engagement’s current working papers and permanent file.

Practice Tip

Be careful when using a proposal or preliminary engagement letter for a client. If the letter describes additional services that are not finally agreed upon, it may be used in litigation as an indication of inadequate performance by you on the engagement. It is a best practice to always make sure that a final engagement letter is issued in such circumstances.

.13 If the nature of an engagement changes during its progress, or if the firm is engaged for additional services during the year, a new engagement letter is generally prepared. A step-down to a compilation or review engagement, or a special engagement for preparing a forecast, are examples of changes that could necessitate a new engagement letter. Such changes are ordinarily made by the engagement partner after...
careful consideration of the reasons justifying the change. For example, the reasons justifying a step-down from an audit to a compilation or review may prevent the firm from reporting on the lower level of service.

**Special Considerations**

.14 The following matters may be considered while preparing an engagement letter:

- Whether the circumstances preclude an unqualified opinion, as in these examples:
  - The auditor is retained after the beginning of the client’s fiscal year, did not observe inventories or confirm receivables at the beginning of the year and was unable to gain satisfaction through application of alternative procedures.
  - The client imposes restrictions on the scope of the audit. (AU section 508, *Reports on Audited Financial Statements* [AICPA, *Professional Standards*, vol. 1]).
  - Significant litigation or other matters exist which may affect the opinion.
- Whether the fee should be stated as a range, in hourly rates, as standard per diem charges for the engagement, or as a maximum or flat fee
- The person or persons to whom reports should be addressed
- The number of copies needed of the report and the people to whom they are to be distributed
- Deadlines for reports or analyses
- Out-of-pocket costs
- Additional work not contemplated in the original engagement
- The condition of records or circumstances other than those contemplated in the engagement letter (for example, deficient internal controls)
- A retainer
- One time engagements
- Start up costs when the client changes auditors
- Underwriters’ requirements in connection with public offerings
- The part of the work to be done by other auditors

**Fee Issues**

.15 Two types of fee arrangements, contingent fees and commissions, are prohibited when the arrangement involves certain attest clients (see paragraph .36 following in this section of the manual for details), even though the fee is not related to an attest service.

.16 A contingent fee is an arrangement whereby (1) no fee is charged unless a specified result is attained or (2) the amount of the fee otherwise depends on the results of your firm’s services. Some examples of contingent fees are the following:

- Your firm receives a finder’s fee for helping a client locate a buyer for one of the client’s assets.
- Your firm performs a consulting engagement to decrease a client’s operating costs. The fee is based on a percentage of the cost reduction that the client achieves as a result of your service.

The following are exceptions:

- Fees fixed by a court or other public authority
- In tax matters, fees based on the results of judicial proceedings or the findings of governmental agencies
A commission is any compensation paid to you or your firm for (1) recommending or referring a third party’s product or service to a client or (2) recommending or referring a client’s product or service to a third party. Permitted commissions shall be disclosed to the person or entity you recommend or refer a product or service to.

Examples of commissions are if you or your firm

- refers a client to a financial planning firm that pays you a commission for the referral.
- sells accounting software to a client and receives a percentage of the sales price (a commission) from a software company.
- refers a nonclient to an insurance company client, which pays you a percentage of any premiums subsequently received (a commission) from the nonclient.

The AICPA rule provides an exception for referral fees for recommending or referring a CPA’s services to another entity person or entity. That is, you may (1) receive a fee for referring the services of a CPA to any person or entity or (2) if you are a CPA, pay a fee to obtain a client provided you disclose such receipt or payment to the client. Referral fees are not considered commissions under these specific circumstances. You must inform the client if you receive or pay a referral fee.

You and your firm may not have commission or contingent fee arrangements with a client when your firm also provides one of the following services to a client:

- An audit of financial statements
- A review of financial statements
- A compilation of financial statements when a third party (for example, a bank or investor) will rely on the financial statements and the report does not disclose a lack of independence
- An examination of prospective financial statements

You and your firm may have commission and contingent fee arrangements with persons associated with a client—such as officers, directors, and principal shareholders—or with a benefit plan that is sponsored by a client (that is, the plan itself is not a client). For example, you or your firm may receive a commission from a nonclient insurer if you refer an officer of an attest client to the insurer and the officer purchases a policy. Even when permitted, the existence of a commission arrangement must be disclosed to the person (or entity) to whom the commission relates.

Contents of Engagement Letters

An understanding with the client and an engagement letter regarding an audit of the financial statements generally includes the following matters:

- The objective of the audit is the expression of an opinion on the financial statements.
- Management is responsible for the entity’s financial statements and the selection and application of the accounting policies.
- Management is responsible for establishing and maintaining effective internal control over financial reporting.
- Management is responsible for designing and implementing programs and controls to prevent and detect fraud.
- Management is responsible for identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

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• Management is responsible for making all financial records and related information available to the auditor.

• At the conclusion of the engagement, management will provide the auditor with a letter that confirms certain representations made during the audit.

• The auditor is responsible for conducting the audit in accordance with GAAS. Those standards require that the auditor obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

• An audit includes obtaining an understanding of the entity and its environment, including its internal control, sufficient to assess the risks of material misstatement of the financial statements and to design the nature, timing, and extent of further audit procedures. An audit is not designed to provide assurance on internal control or to identify significant deficiencies. However, the auditor is responsible for ensuring that those charged with governance are aware of any significant deficiencies that come to his or her attention.

• Management is responsible for adjusting the financial statements to correct material misstatements and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

.23 The engagement letter is generally addressed to those charged with governance, the chief executive, or whoever retained the firm. If the engagement letter also serves as the method of communicating the auditor’s responsibilities under AU section 380, The Auditor’s Communication With Those Charged With Governance (AICPA, Professional Standards, vol. 1), the addressee should include those persons charged with governance. See further discussion in paragraph .29 in this section of this manual. The engagement partner may sign the letter on behalf of the firm. The client representative responsible for the engagement signs the letter denoting agreement with the contract. The original letter may be maintained in the engagement documentation. A copy of the letter is given to the client.

.24 An understanding with the client and an engagement letter may include other matters, such as the following:

• The overall audit strategy.

• Involvement of specialists or internal auditors, if applicable.

• Involvement of a predecessor auditor.

• Fees and billing. Estimates of fees are usually based on conservative, carefully prepared estimates. It may be useful to describe the expected billing methods and payment periods.

• Any limitation of or other arrangements regarding the liability of the auditor or the client, such as indemnification to the auditor for liability arising from knowing misrepresentations to the auditor by management (regulators, such as the Securities and Exchange Commission, may restrict or prohibit such liability limitation arrangements).

• Conditions under which access to the auditor’s documentation may be granted to others.

• Additional services to be provided relating to regulatory requirements.

• Other services to be provided in connection with the engagement, for example, nonattest services, such as accounting assistance and preparation of tax returns subject to the limitations of Interpretation No. 101-3, “Performance of nonattest services,” under Rule 101, Independence (AICPA, Professional Standards, vol. 2, ET sec. 101 par. .05).
The client assistance schedule is usually tailored to each specific engagement. The following is a list of analyses, schedules and other items that are often requested from the client prior to the start of an audit engagement:

- The general ledger.
- A reconciliation for each bank account.
- A trade accounts receivable aging.
- Accounts receivable confirmation letters, using drafts to be provided by the auditor.
- A schedule of accounts receivable from officers and employees.
- A schedule of bad debts written off during the year.
- A schedule of notes receivable. The notes should be available for inspection.
- A schedule of transactions with affiliated enterprises.
- An inventory listing.
- An analysis of transactions affecting marketable securities.
- An insurance schedule. The policies should be available for inspection.
- A schedule of property and equipment additions and retirements.
- A depreciation schedule.
- A schedule of life insurance for officers.
- A schedule of accounts payable. The creditor’s regular monthly statements for [date] should be retained and made available.
- A schedule of notes payable.
- The corporate stock book and minutes should be up to date and available for inspection.
- A schedule of all transactions to partners’ capital and drawing accounts.
- A copy of the partnership agreement or corporate charter should be available for inspection.
- Copies of all leases, including equipment rental contracts, should be available for inspection.
- Copies of employment contracts with salesmen or executives should be available for inspection.
- Copies of pension, profit sharing, deferred compensation, stock option agreements, and letters of acceptance from the Treasury Department, should be available for inspection.
- A schedule of repairs in excess of $________.
- A schedule of each officer’s salary and expense account payments.
- A schedule of contributions.
- A schedule of tax expense.
- A schedule of professional fees.

Following is a list of common engagement letter deficiencies:

- Reference in the letter to audit of the books and records rather than to audit of financial statements
- Adverse comments about other firms
- Failure to specify in detail the services to be rendered when a maximum fee is quoted
- Inclusion of a review of internal control as one of the services when what is really intended is an understanding of internal control as required by auditing standards
• Failure to identify accounting or other problems that may have an effect on the opinion
• Failure to change, in writing, the terms of the engagement when conditions are found to be different (such as the inability to express an opinion without extensive additional auditing because internal control was found deficient)
• Failure to include fee basis and payment terms
• Failure to identify subsidiaries
• Failure to identify specific tax returns to be prepared
• Failure to document the scope of the engagement

**Investigatory Procedures for Individuals**

.27 When credit information is requested about individuals who are new clients, the investigative procedures are subject to the Fair Credit Reporting Act.

.28 Under the Fair Credit Reporting Act, an individual is informed in writing that an investigative consumer report, including information about the individual’s character, general reputation, personal characteristics, and mode of living is being made. The individual is also advised, within three days of the time the report is requested, that he or she may, within a reasonable time, by written request, be furnished disclosure of the nature and scope of the investigation.

**Sample Engagement Letters**

.29 See AAM section 3165 for sample engagement letters.

**Preliminary Engagement Activities**

.30 In addition to the procedures mentioned previously, at the beginning of the audit engagement the auditor should (1) perform procedures regarding the continuance of the client relationship and the specific audit engagement and (2) evaluate the auditor’s compliance with ethical requirements, including independence. The purpose of performing these preliminary engagement activities is to consider any events or circumstances that may either adversely affect the auditor’s ability to plan and perform the audit engagement to reduce audit risk to an acceptably low level or may pose an unacceptable level of risk to the auditor.

**The Overall Audit Strategy**

.31 In establishing the overall audit strategy, the auditor should (1) determine the characteristics of the engagement that define its scope, such as the basis of reporting, industry specific reporting requirements, and the locations of the entity; (2) ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required, such as deadlines for interim and final reporting, and key dates for expected communications with management and those charged with governance; and (3) consider the important factors that will determine the focus of the audit team’s efforts, such as determination of appropriate materiality levels, preliminary identification of areas where there may be higher risks of material misstatement, preliminary identification of material locations and account balances, evaluation of whether the auditor may plan to obtain evidence regarding the operating effectiveness of internal control, and identification of recent significant entity specific, industry, financial reporting, or other relevant developments. The appendix to AU section 311 provides examples of matters the auditor may consider in establishing the overall audit strategy.

**The Audit Plan**

.32 The auditor must develop an audit plan in which the auditor documents the audit procedures to be used that, when performed, are expected to reduce audit risk to an acceptably low level. The audit plan is more detailed than the audit strategy and includes the nature, timing, and extent of audit procedures to be
performed by audit team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Documentation of the audit plan also serves as a record of the proper planning and performance of the audit procedures that can be reviewed and approved prior to the performance of further audit procedures. The audit plan should include the following:


- A description of the nature, timing, and extent of planned further audit procedures at the relevant assertion level for each material class of transactions, account balance, and disclosure, as determined under AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1). The plan for further audit procedures reflects the auditor’s decision whether to test the operating effectiveness of controls and the nature, timing, and extent of planned substantive procedures.

- A description of other audit procedures to be carried out for the engagement in order to comply with GAAS (for example, seeking direct communication with the entity’s lawyers).

**Determining the Extent of Involvement of Professionals Possessing Specialized Skills**

.33 The auditor should consider whether specialized skills are needed in performing the audit. If specialized skills are needed, the auditor should seek the assistance of a professional possessing such skills, who may be either on the auditor’s staff or an outside professional. If the use of such a professional is planned, the auditor should determine whether that professional will effectively function as a member of the audit team. If such a professional is part of the audit team, the auditor’s responsibilities for supervising that professional are equivalent to those for other assistants. In such circumstances, the auditor should have sufficient knowledge to communicate the objectives of the other professional’s work; to evaluate whether the specified audit procedures will meet the auditor’s objectives; and to evaluate the results of the audit procedures applied as they relate to the nature, timing, and extent of further planned audit procedures.

.34 The use of professionals possessing IT skills to determine the effect of IT on the audit, to understand the IT controls, or to design and perform tests of IT controls or substantive procedures is a significant aspect of many audit engagements. In determining whether such a professional is needed on the audit team, the auditor should consider such factors as the following:

- The complexity of the entity’s systems and IT controls and the manner in which they are used in conducting the entity’s business
- The significance of changes made to existing systems, or the implementation of new systems
- The extent to which data is shared among systems
- The extent of the entity’s participation in electronic commerce
- The entity’s use of emerging technologies
- The significance of audit evidence that is available only in electronic form

.35 Audit procedures that the auditor may assign to a professional possessing IT skills include inquiring of an entity’s IT personnel how data and transactions are initiated, authorized, recorded, processed, and reported and how IT controls are designed; inspecting systems documentation; observing the operation of IT controls; and planning and performing tests of IT controls.
Communications With Those Charged With Governance and Management

.36 Paragraph .23 of AU section 380 explains that, among other matters, the auditor should communicate with those charged with governance (1) the auditor’s responsibilities under GAAS and (2) an overview of the planned scope and timing of the audit.

Additional Considerations in Initial Audit Engagements

.37 Before starting an initial audit, the auditor should perform procedures regarding the acceptance of the client relationship and the specific audit engagement (see Statement on Quality Control Standards No. 7, A Firm’s System of Quality Control [AICPA, Professional Standards, vol. 2, QC sec. 10]) and communicate with the previous auditor, where there has been a change of auditors (see AU section 315, Communication Between Predecessor and Successor Auditors [AICPA, Professional Standards, vol. 1]). The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not have the previous experience with the entity that is considered when planning recurring engagements. Paragraph .27 of AU section 311 provides additional matters the auditor should consider in developing the overall audit strategy and audit plan for an initial audit.

[The next page is 3121.]
AAM Section 3105

Understanding the Assignment

.01 The auditor may (a) meet with the client to understand the type, scope, and timing of the engagement; (b) understand if reports on compliance, internal control, or segments of the entity are required; (c) understand the client’s expectations, both stated and implied; and (d) review the expectations of both the owners and managers.

.02 To obtain an adequate understanding of any assignment, the auditor should be familiar with generally accepted accounting principles (GAAP), which includes specialized AICPA industry guides as well as Emerging Issues Task Force (EITF) consensuses. The auditor should also be familiar with generally accepted auditing standards (GAAS), which are promulgated by the AICPA and must be followed.


.04 On July 1, 2009, the Financial Accounting Standards Board (FASB) formally approved the FASB *Accounting Standards Codification™* (ASC) as the source of authoritative GAAP to be applied by nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission. The FASB ASC eliminates the GAAP hierarchy for nongovernmental entities by integrating U.S. GAAP into a single authoritative codification. The FASB ASC includes all accounting standards issued by a standard-setter within levels A–D of the former U.S. GAAP hierarchy, including FASB, AICPA, EITF, and related literature. The codification does not change GAAP; instead it reorganizes the thousands of U.S. GAAP pronouncements into roughly 90 accounting topics and displays all topics using a consistent structure. Financial accounting and reporting literature is either authoritative (in the FASB ASC) or nonauthoritative (not in the FASB ASC). Additional information is available in the AICPA Financial Reporting Alert, *FASB Codification Developments—2008* (product no. 029209), which includes screen shots and detailed instructions on using the ASC or through the FASB ASC Research System at http://asc.fasb.org.

Generally Accepted Auditing Standards

.05 An independent auditor plans, conducts, and reports the results of an audit in accordance with GAAS. Auditing standards provide a measure of audit quality and the objectives to be achieved in an audit. Auditing procedures differ from auditing standards. Auditing procedures are acts that the auditor performs during the course of an audit to comply with auditing standards.

.06 AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1), provides a framework of GAAS.

.07 The general, field work, and reporting standards (the 10 standards) are as follows:

*General Standards*

1. The auditor must have adequate technical training and proficiency to perform the audit.
2. The auditor must maintain independence in mental attitude in all matters relating to the audit.
3. The auditor must exercise due professional care in the performance of the audit and the preparation of the report.
Standards of Fieldwork

1. The auditor must adequately plan the work and must properly supervise any assistants.

2. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

3. The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

1. The auditor must state in the auditor’s report whether the financial statements are presented in accordance with GAAP.

2. The auditor must identify in the auditor’s report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

3. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor’s report.

4. The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor’s report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefor in the auditor’s report. In all cases where an auditor’s name is associated with financial statements, the auditor should clearly indicate the character of the auditor’s work, if any, and the degree of responsibility the auditor is taking, in the auditor’s report.

.08 Rule 202, Compliance With Standards (AICPA, Professional Standards, vol. 2, ET sec. 202 par. .01), of the AICPA Code of Professional Conduct requires an AICPA member who performs an audit (the auditor) to comply with standards promulgated by the Auditing Standards Board (ASB). The ASB develops and issues standards in the form of Statements on Auditing Standards (SASs) through a due process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. The SASs are codified within the framework of the 10 standards.

.09 The nature of the 10 standards and the SASs requires the auditor to exercise professional judgment in applying them. Materiality and audit risk also underlie the application of the 10 standards and the SASs, particularly those related to field work and reporting. The auditor should be prepared to justify departures from the SASs. When, in rare circumstances, the auditor departs from a presumptively mandatory requirement, the auditor must document in the working papers his or her justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement.

.10 Interpretive publications consist of auditing interpretations of the SASs, appendixes to the SASs, auditing guidance included in AICPA Audit and Accounting Guides, and AICPA auditing Statements of

1 See paragraph .06 of AU section 326, Audit Evidence (AICPA, Professional Standards, vol. 1), for the definition of the term appropriate.

2 The reporting standards apply only when the auditor issues a report.

3 When an auditor reports on financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the first standard of reporting is satisfied by stating in the auditor’s report that the basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles and by expressing an opinion (or disclaiming an opinion) on whether the financial statements are presented in conformity with the comprehensive basis of accounting used.

4 See AU section 312, Audit Risk and Materiality in Conducting an Audit (AICPA, Professional Standards, vol. 1).

5 Appendixes to the Statements on Auditing Standards (SASs) referred to in paragraph .05 of AU section 150, Generally Accepted Auditing Standards (AICPA, Professional Standards, vol. 1), do not include previously issued appendixes to original pronouncements that when adopted modified other SASs.
Interpretive publications are not auditing standards. Interpretive publications are recommendations on the application of the SASs in specific circumstances, including engagements for entities in specialized industries. An interpretive publication is issued under the authority of the ASB after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with the SASs.

The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he complied with the SAS provisions addressed by such auditing guidance.

Other auditing publications include the following:

- AICPA auditing publications not referred to previously
- Auditing articles in the *Journal of Accountancy* and other professional journals
- Auditing articles in the AICPA *CPA Letter*
- Continuing professional education programs and other instructional materials, textbooks, guide books, audit programs and checklists; and other auditing publications from state CPA societies, other organizations and individuals.

Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the SASs.

If an auditor applies the auditing guidance included in an other auditing publication, he should be satisfied that, in his judgment, it is both relevant to the circumstances of the audit, and appropriate. In determining whether an other auditing publication is appropriate, the auditor may wish to consider the degree to which the publication is recognized as being helpful in understanding and applying the SASs and the degree to which the issuer or author is recognized as an authority in auditing matters. Other auditing publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are presumed to be appropriate.

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6 Auditing interpretations of the SASs are included in the codified version of the SASs. AICPA Audit and Accounting Guides and auditing Statements of Position are listed in AU appendix D, "AICPA Audit and Accounting Guides and Statements of Position" (AICPA, *Professional Standards*, vol. 1).

7 The auditor is not expected to be aware of the full body of other auditing publications.

8 Other auditing publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff as listed in AU appendix F, "Other Auditing Publications" (AICPA, *Professional Standards*, vol. 1).
AAM Section 3110

Assigning Personnel to the Engagement and Supervision

General Comments

.01 Engagement planning includes procedures for assigning personnel to the engagement. Having procedures established provides the firm with reasonable assurance that work will be performed by persons having the degree of technical training and proficiency required in the circumstances. Generally, the more able and experienced the personnel assigned to a particular engagement, the less need for direct supervision.

.02 Some procedures regarding assignment of personnel to the engagement are discussed in this section. The specific procedures adopted by a firm would not necessarily include all the procedures or be limited to those discussed. Overall firm guidance for assigning personnel to engagements is addressed in the practice aid Establishing and Maintaining a System of Quality Control for a CPA Firm’s Accounting and Auditing Practice (product no. 006636), and in “A Firm’s System of Quality Control” in AAM section 10,200. Sample quality control forms are available at AAM section 10,300, which are helpful in assigning personnel to engagements.

Engagement Planning Procedures

.03 A time budget for the engagement is prepared to determine manpower requirements and to schedule field work. The engagement partner may approve the time budget prior to the beginning of field work. A time budget may have columns for budgeted time (in hours) for preliminary and final field work. Time budget forms differ depending upon firm preference and needs. Some firms use separate forms for the time budget report and the job progress report or analysis (see paragraph .01 of AAM section 3160 for “Audit Time Budget—Sample A’”), whereas others combine these reports into one form (see paragraph .02 of AAM section 3160 for “Audit Time Budget—Sample B”).

.04 Other alternatives include longer, more detailed sets of forms. These forms combine the features of a time budget, a source document for staff scheduling, and a job progress report that compares each assigned person’s actual daily hours against the budget. Some firms use a shorter, less detailed form for jobs of less than a predetermined number of staff hours (for example, 100 hours; see paragraph .03 of AAM section 3160 for “Audit Time Analysis—Short Form”) and a longer form for jobs requiring more time (see paragraph .04 of AAM section 3160 for “Audit Time Analysis—Long Form”). Some firms use a weekly (or daily) progress report (see paragraph .05 of AAM section 3160, for example). This report, submitted by the auditor in charge, shows the time actually spent in relation to the estimate, the estimated additional time required, and the estimated variance from the original estimate.

.05 When the combined time budget and progress report form (sample B) is used, it is kept current as the assignment progresses. This form is carried in the working papers file and is filled in daily by the auditor in charge for all persons applying time on the engagement. This procedure is vital to identify and control time because it is applied so that it can be compared to the budgeted time for that phase of the engagement.

.06 The following factors may be considered in achieving a balance of engagement manpower requirements, personnel skills, individual development, and utilization:

a. Engagement size and complexity
b. Personnel availability  
c. Special expertise  
d. Timing of the work to be performed  
e. Continuity and periodic rotation of personnel  
f. Opportunities for on-the-job training  

The scheduling and staffing of the engagement is approved by the partner with final responsibility for the engagement so that the partner can consider the qualifications, experience, and training of personnel to be assigned. The experience and training of the engagement personnel is considered in relation to the complexity or other requirements of the engagement and the extent of supervision to be provided.

It is recommended that the auditor document all procedures discussed in this section in the auditor’s working papers.

Supervision

Supervision involves directing the efforts of assistants who are involved in accomplishing the objectives of the audit and determining whether those objectives were accomplished. Elements of supervision include instructing assistants, keeping informed of significant issues encountered, reviewing the work performed, and dealing with differences of opinion among firm personnel. The extent of supervision appropriate in a given instance depends on many factors, including the complexity of the subject matter and the qualifications of persons performing the work, including knowledge of the client’s business and industry.

The auditor with final responsibility for the audit should communicate with members of the audit team regarding the susceptibility of the entity’s financial statements to material misstatement due to error or fraud, with special emphasis on fraud. Such discussion helps all audit team members understand the entity and its environment, including its internal control, and how risks that the entity faces may affect the audit. The discussion should emphasize the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating evidence throughout the audit.

In addition, assistants should be informed of their responsibilities and the objectives of the audit procedures they are to perform. They should be informed of matters that may affect the nature, timing, and extent of audit procedures they are to perform, such as the nature of the entity’s business as it relates to their assignments and possible accounting and auditing issues. The auditor with final responsibility for the audit should direct assistants to bring to his or her attention accounting and auditing issues raised during the audit that the assistant believes are of significance to the financial statements or auditor’s report so the auditor with final responsibility may assess their significance. Assistants also should be directed to bring to the attention of appropriate individuals in the firm difficulties encountered in performing the audit, such as missing documents or resistance from client personnel in providing access to information or in responding to inquiries.

The work performed by each assistant, including the audit documentation, should be reviewed to determine whether it was adequately performed and documented and to evaluate the results, relative to the conclusions to be presented in the auditor’s report.

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1 For further guidance on the discussion among the audit team, see paragraphs .14–.18 of AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), and paragraphs .14–.20 of AU section 314, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (AICPA, Professional Standards, vol. 1).
.13 Each assistant has a professional responsibility to bring to the attention of appropriate individuals in the firm disagreements or concerns with respect to accounting and auditing issues that the assistant believes are of significance to the financial statements or auditor’s report, however those disagreements or concerns may have arisen. The auditor with final responsibility for the audit and assistants should be aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among firm personnel involved in the audit. Such procedures should enable an assistant to document his or her disagreement with the conclusions reached if, after appropriate consultation, he or she believes it necessary to disassociate himself or herself from the resolution of the matter. In this situation, the basis for the final resolution should also be documented.

[The next page is 3161.]
AAM Section 3115

Independence

General Comments

.01 In accordance with Rule 101, Independence (AICPA, Professional Standards, vol. 2, ET sec. 101 par. .01), of the AICPA Code of Professional Conduct, a member in public practice shall be independent in the performance of professional services, as required by standards promulgated by bodies designated by council, which includes but is not limited to attest engagements.¹ Attest engagements are those in which your firm attests—or affirms—that a client’s financial or other information is reasonably stated. Examples of attest services are

- financial statement audits,
- financial statement reviews, and
- other attest services as defined in the Statements on Standards for Attestation Engagements.

.02 Third parties—investors, creditors, and others—rely on your firm’s attestations about a client’s financial information when making various business decisions. Therefore, attest services have value for third parties only if an independent firm renders the services. Accordingly, AICPA Professional Standards states that the auditor must maintain independence in mental attitude in all matters relating to the audit; therefore, your firm may perform attest services for a client only when it is independent of that client. Independence is not required to perform the following services, if these are the only services your firm provides to a client:

1. Tax preparation and advice
2. Consulting services (such as tax consulting or personal financial planning)

.03 One other service—a compilation of a client’s financial statements—does not require independence. If a nonindependent firm issues a compilation report, the following should be included as the last paragraph of the report, “I am (we are) not independent with respect to XYZ Company.”²

.04 Engagement planning includes procedures to provide the firm with reasonable assurance that all persons required to maintain independence, to the extent required by the AICPA Code of Professional Conduct and the regulations of other organizations, as applicable (for example, the Securities and Exchange Commission [SEC], and the Department of Labor), do so. The interpretations and rulings under Ethics Rule 101 of the AICPA Code of Professional Conduct contain examples of instances wherein a firm’s independence will be considered to be impaired.

.05 As stated in the following text, audit firms that perform audits of or perform other attest services for public companies or other SEC registrants should consult the independence rules of the SEC and the Public Company Accounting Oversight Board (PCAOB).

.06 Other organizations that have established other independence requirements that a member should consult if applicable include the following:

- State boards of accountancy
- State CPA societies
- Federal and state agencies, such as the Governmental Accountability Office (GAO)

¹ There are additional requirements for public companies and companies subject to other governmental oversight.
Generally, the AICPA independence rules will apply to you in all situations involving an attest client. If an additional set of rules governing an engagement also applies, you should comply with the most restrictive rule or the most restrictive portions of each rule. The AICPA’s Practice Aids, *Independence Compliance—Checklists and Tools for Complying With AICPA and GAO Independence Requirements* (product no. 006661), and *Independence Compliance: Checklists and Tools for Complying with AICPA, SEC, and PCAOB Independence Requirements* (product no. 006660), are valuable resources for helping practitioners observe applicable independence rules. The practice aids can be obtained at [www.cpa2biz.com](http://www.cpa2biz.com) or by calling (888) 777-7077.

**Maintaining Your Independence**

Maintaining your independence is your responsibility, not your firm’s. As part of its quality control system, the firm is often required to address independence matters; however, ultimately it is up to you to follow firm policies and the independence rules. Many firms require you to certify your independence on a regular basis. The following are some suggestions that will help you to complete and sign that certification in good faith.

**Gain an understanding of the independence rules and firm policies.** As a prerequisite to establishing and maintaining the independence, a good, working understanding of the basic independence rules is essential. At a minimum, it is important to be aware of the circumstances in which you and your immediate family meet the definition of a covered member (discussed in the following section in greater detail) and of the types of relationships you may have with the firm’s clients that could impair independence. If you have any questions about independence matters, you may consult with someone in your firm who is knowledgeable about such matters, or you may seek the advice of the AICPA (ethics@aicpa.org). If your firm performs audits and other attest services for SEC registrants, you should also familiarize yourself with rules promulgated by the SEC and the PCAOB.

**Covered Member**

Know when you meet the definition of a covered member. Whenever you are a covered member with respect to a particular attest client, you become subject to the highest possible level of independence restrictions (for example, restrictions on financial and business interests, and your family’s employment). According to paragraph .06 of ET section 92, *Definitions* (AICPA, *Professional Standards*, vol. 2), you are a covered member with respect to a client if you are

1. an individual on the attest engagement team;
2. an individual in a position to influence the attest engagement;
3. a partner or manager who provides more than ten hours of nonattest services to the attest client;
4. a partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement;
5. the firm, including the firm’s employee benefit plans; or
6. an entity whose operating, financial, or accounting policies can be controlled (as defined by generally accepted accounting principles [GAAP] for consolidation purposes) by any of the individuals or entities described in (1)–(5) or by two or more such individuals or entities if they act together.

However, due to their magnitude, two relationships with a client impair independence even when you are not a covered member.

The following rules apply to partners and professional employees of a firm who are not covered members:

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3 The staff of the AICPA Professional Ethics Division prepared a plain-English digest of the AICPA independence rules to help you understand independence requirements under the AICPA Code of Professional Conduct and, if applicable, other rule-making and standard-setting bodies. This digest of the AICPA independence rules is available on the AICPA Professional Ethics Division’s Web site at [www.aicpa.org](http://www.aicpa.org).
• No partner or professional employee may be simultaneously associated with an attest client during the period covered by the financial statements or during the period of the professional engagement as a
  — director, officer, or employee (or in any capacity equivalent to a member of management),
  — promoter, underwriter, or voting trustee, or
  — trustee of any of the client’s pension or profit-sharing trust.

• No partner or professional employee, his or her immediate family, or any group of such persons acting together may own more than 5 percent of an attest client’s outstanding equity securities (or other ownership interests).

Family Members

.12 The investments and employment of certain family members may impair your independence. Know which of your family members meet the definition of immediate family and which ones meet the definition of close relative as defined in ET section 92.

.13 If you are a covered member with respect to a client, members of your immediate family (your spouse, spousal equivalent, or dependents [whether related or not]) should follow the same rules as you. So, for example, your spouse’s investments should be investments that you could own under the rules. This would be the case even if your spouse keeps the investments in his or her own name or with a different broker.

.14 There are two exceptions to this general rule.

1. Your immediate family member’s employment with a client would not impair your firm’s independence provided he or she is not in a key position. A key position is one in which your family member
   • has primary responsibility for significant accounting functions that support material components of the financial statements or the preparation of the financial statements;
   • has primary responsibility for preparing the financial statements; or
   • has the ability to exercise influence over the contents of the financial statements, including when the individual is a member of the board of directors or similar governing body, CEO, president, CFO, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.

2. Immediate family members of certain covered members may have a financial interest in a client through an employee benefit plan (for example, retirement or savings account) provided the plan is offered equitably to all similar employees. The covered members whose families may have such interests are the following:
   • Partners and managers who provide ten or more hours of nonattest services to the client
   • Partners who are in the same office where the client’s lead attest partner practices in connection with the engagement

.15 Also note that immediate family of individuals on the attest engagement team or of those who can influence the attest engagement team may not apply this exception.

.16 The close relatives of certain covered members will be subject to some employment and financial restrictions. These covered members are
   • persons on the attest engagement team,
   • persons who can influence the attest engagement, and
   • any partners in the office where the client’s lead partner the attest engagement.
Close relatives are your
• nondependent children,
• siblings, or
• parents.

So, as a covered member, your close relative’s employment by a client would impair independence if your relative had a key position with the client.

Rules pertaining to your close relatives’ financial interests differ depending on why you are considered a covered member:
• If you are a covered member because you participate on the client’s attest engagement team, your independence would be considered to be impaired if you are aware that your close relative has a financial interest in the client that either
  — was material to your relative’s net worth and of which you have knowledge or
  — enables the relative to exercise significant influence over the client.
• If you are a covered member because you are able to influence the client’s attest engagement or are a partner in the office in which the lead attest engagement partner practices in connection with the engagement, your independence will be impaired if you are aware that your close relative has a financial interest in the client that
  — is material to your relative’s net worth and of which you or the partner have knowledge and
  — enables your relative to exercise significant influence over the client.

Financial Relationships

There are various types of financial interests and some of those interests affect independence. Although your firm and its employee benefit plans are also subject to the financial interest provisions of the independence rules (firms are included in the definition of covered member), here we focus on their application to individuals.

As a covered member with respect to a particular client, you (and your spouse, or equivalent, and dependents) may not have a
• direct financial interest in that client, regardless of how immaterial it would be to your net worth.
• material indirect financial interest in that client.

In addition, if you commit to acquire a financial interest in a client with respect to which you are a covered member, your independence would be impaired. For example, if you sign a stock subscription agreement with the client, your independence would be considered impaired as soon as you sign the agreement.

According to paragraph .17 of ET section 101, Independence (AICPA, Professional Standards, vol. 2), a financial interest is an ownership interest in an equity or a debt security issued by an entity, including rights and obligations to acquire such an interest and derivatives directly related to such interest. Examples of financial interests include shares of stock; mutual fund shares; partnership units; stock rights; options or warrants to acquire an interest in a client; or rights of participation, such as puts, calls, or straddles.

Direct financial interests are financial interests that are
• owned by you directly;
• under your control; or
beneficially owned by you through an investment vehicle, estate, trust, or other intermediary if you can either

— control the intermediary, or

— have the authority to supervise or participate in the intermediary’s investment decisions.

For example, if you invest in a participant directed 401(k) plan, whereby you are able to select the investments held in your account or are able to select from investment alternatives offered by the plan, you would be considered to have a direct financial interest in the investments held in your account.

.25 You also have a direct financial interest in a client when you have a financial interest in a client through one of the following:

- A partnership, if you are a general partner.
- A Section 529 savings plan, if you are the account owner.
- An estate, if you serve as an executor and meet certain other criteria.
- A trust, if you serve as the trustee and meet certain other criteria.

.26 Indirect financial interests arise if you have a financial interest that is beneficially owned through an investment vehicle, estate, trust, or other intermediary when you can neither control the intermediary nor have the authority to supervise or participate in the intermediary’s investment decisions. For example, if you invest in a defined contribution plan that is not participant directed and you have no authority to supervise or participate in the plan’s investment decisions, you would be considered to have an indirect financial interest in the underlying plan investments, in addition to a direct financial interest in the plan.

Business Relationships

.27 As a partner or professional employee of your firm, independence would be considered to be impaired if you entered into certain business relationships with an attest client of the firm. Accordingly, you may not serve a client as any of the following:

- Director, officer, employee, or in any management capacity
- Promoter, underwriter, or voting trustee
- Stock transfer or escrow agent
- General counsel (or equivalent)
- Trustee for a client’s pension or profit-sharing trust

.28 In essence, any time you are able to make management decisions on behalf of a client or exercise authority over a client’s operations or business affairs, independence is considered impaired.

.29 Your independence is considered impaired even if you were a volunteer board member because you would be part of the client’s governing body and therefore would be able to participate in the client’s management decisions.

.30 This rule has two possible exceptions:

1. If you are an honorary director or trustee for a client that is a nonprofit charitable, civic, or religious organization, you may hold such position with a client if
   a. your position is purely honorary.
   b. you do not vote or participate in managing the organization.
   c. your position is clearly identified as honorary in any internal or external correspondence.
2. In addition, you may serve on a client’s advisory board provided all the following criteria are met:
   a. The advisory board’s function is purely advisory.
   b. The advisory board does not appear to make decisions for the client.
   c. The advisory board and any decision making boards are separate and distinct bodies.
   d. Common membership between the advisory board and any decision making groups is minimal.

Practice Tip
Before accepting an invitation to serve on a client’s advisory board, a covered member may ask to review
the advisory board’s governing document to verify that the advisory board’s function is indeed purely
advisor and that the advisory board indeed does not make decisions for the client.

Unpaid Fees

.31 If a client of the member’s firm has not paid fees for previously rendered professional services, then
independence is considered to be impaired if, when the report on the client’s current year is issued, billed or
unbilled fees, or a note receivable arising from such fees, remain unpaid for any professional services provided
more than one year prior to the date of the report.

Restricted Entities

.32 Be familiar with the firm’s restricted entities. Restricted entities are those entities for whom the firm
provides attest services. Many firms maintain a formal list or database of these clients. If yours is one of these
firms, you should know how to access the list.

.33 Maintain the integrity of the restricted entity list. If you perform attest services, then you need to make
sure that those clients are identified as restricted entities of the firm. Certain entities that are related to your
clients (for example, subsidiaries) also will be considered restricted entities, even if they are not clients of the
firm.

.34 Consult the restricted entities list regularly. Get into the habit of referring to the firm’s restricted entity
list whenever you are considering changes in circumstances that could affect your independence. For example,
you may consult the restricted entity list prior to
   • making an investment or acquiring a financial interest in an entity.
   • entering into a business relationship.
   • obtaining a loan or refinancing an existing loan.
   • having an immediate family member change employers or assume new responsibilities at an existing
     job.

Nonattest Services

.35 Be aware of the rules relating to the performance of nonattest services. If you provide nonattest services
to restricted entities, you should be familiar with Interpretation No. 101-3, “Performance of nonattest
services,” of ET section 101 (AICPA, Professional Standards, vol. 2, ET sec. 101 par. .05) that establishes standards
and provides guidance regarding the performance of nonattest services. Interpretation No. 101-3 discusses the
services that are permitted and prohibited under the ruling, as well as the member’s responsibilities for
establishing an understanding of the engagement with your client and documenting various aspects of the

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4 The staff of the Professional Ethics Division issued nonauthoritative guidance in the form of a frequently asked question (FAQ)
regarding performance of nonattest services. The FAQ document, is available on the AICPA Professional Ethics Division’s Web site at
www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+
Ethics/Resources+and+Tools/Frequently+Asked+Questions.htm#appraisalvaluation.
engagement. If your clients are SEC registrants, you should be aware of the more restrictive SEC rules in this area. Certain other regulators (for example, the GAO) may have more restrictive rules concerning nonattest services, which should be reviewed depending upon the circumstances of the engagement.

.36 The term nonattest services includes accounting and consulting services that are not part of an attest engagement. Nonattest services specifically addressed in the rules are as follows:

- Bookkeeping services
- Nontax disbursement services
- Internal audit assistance
- Benefit plan administration
- Investment advisory or management services
- Tax compliance services
- Corporate finance consulting or advisory
- Appraisal, valuation, or actuarial services
- Executive or employee search services
- Business risk consulting
- Information systems design, installation, or integration
- Forensic accounting services

.37 Interpretation No. 101-3 lists three general requirements in order to maintain independence when performing permitted nonattest services.

.38 The first of the three general requirements of Interpretation No. 101-3 states that a member should not perform—or even appear to perform—management functions or make management decisions for an attest client. (However, the member may provide advice, research materials, and recommendations to assist the client’s management in performing its functions and making decisions.)

.39 The second general requirement is that the client must agree to perform the following functions in connection with the engagement:

- Make all management decisions and perform all management functions
- Designate an individual who possesses suitable skill, knowledge, or experience, preferably within senior management, to oversee the services
- Evaluate the adequacy and results of the services performed; and
- Accept responsibility for the results of the services

The member should be satisfied that the client will be able to meet all of these criteria and to make an informed judgment on the results of the member’s nonattest services. In assessing whether the designated individual possesses suitable skill, knowledge, or experience, the member should be satisfied that the individual understands the services to be performed sufficiently to oversee them. However, the individual is not required to possess the expertise to perform or reperform the services. In cases where the client is unable or unwilling to assume these responsibilities (for example, the client does not have an individual with suitable skill, knowledge, or experience to oversee the nonattest services provided, or is unwilling to perform such functions due to lack of time or desire), the member’s provision of these services would impair independence.

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[5] As defined in the Code of Professional Conduct, an attest engagement is one that requires independence under AICPA Professional Standards; for example, audits and reviews of financial statements or agreed upon procedures performed under the attestation standards.
The third general requirement is that before performing nonattest services, the member should establish and document in writing his or her understanding with the client (for example, the board of directors, audit committee, or management, as appropriate in the circumstances) regarding the following:

- Objectives of the engagement
- Services to be performed
- Client’s acceptance of its responsibilities
- Member’s responsibilities
- Any limitations of the engagement

The understanding might be documented in a separate engagement letter, in the working papers, or in an internal memo, or it might be included in an engagement letter obtained in conjunction with an attest engagement.

The second and third general requirements do not apply to certain routine activities performed by the member, such as, assisting clients with technical accounting questions, advising on internal controls, or providing periodic training on new pronouncements that are part of the normal client-member relationship.

In addition, the following are examples of the types of activities that impair independence:

- Authorizing, executing, or consummating a transaction, or otherwise exercising authority on behalf of a client or having the authority to do so
- Preparing source documents, in electronic or other form, evidencing the occurrence of a transaction
- Having custody of client assets
- Supervising client employees in the performance of their normal recurring activities.
- Determining which recommendations of the member should be implemented.
- Reporting to the board of directors on behalf of management.
- Serving as a client’s stock transfer or escrow agent, registrar, general counsel, or its equivalent.
- Establishing and maintaining internal controls, including performing ongoing monitoring activities for a client

Additionally, Interpretation No. 101-3 requires you comply with more restrictive independence provisions, if applicable, of certain regulators such as state boards of accountancy, the SEC, and the GAO.

Report any apparent violations. If you become aware of any apparent violations of the independence rules, you should report these immediately to the person in your firm responsible for independence matters.

The procedures employed at the engagement level should be designed to ascertain whether the firm and its partners and employees have complied with all applicable independence rules. Overall firm requirements for independence are addressed in Statement on Quality Control Standards (SQCS) No. 7, A Firm’s System of Quality Control (AICPA, Professional Standards, vol. 2, QC sec. 10).

Independence Quality Controls

Paragraph .21 of SQCS No. 7 states that the firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel, and, where applicable, others subject to independence requirements, maintain independence where required. Independence requirements are set forth in ET section 101 and its related interpretations and rulings of the AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies. Guidance on threats to independence, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time and safeguards to mitigate such threats involving
matters that are not explicitly addressed in the AICPA Code of Professional Conduct are set forth in ET section 100, *Conceptual Framework for AICPA Independence Standards* (AICPA, *Professional Standards*, vol. 2). Such policies and procedures should enable the firm to

- communicate its independence requirements to its personnel and, where applicable, others subject to them.
- identify and evaluate circumstances and relationships that create threats to independence and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if effective safeguards cannot be applied, withdrawing from the engagement.

.47 Such policies and procedures should require

- the engagement partner to consider relevant information about client engagements, including the scope of services, to enable him or her to evaluate the overall effect, if any, on independence requirements.
- personnel to promptly notify the engagement partner and the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken.
- the accumulation and communication of relevant information to appropriate personnel so that
  1. the firm, the engagement partner, and other firm personnel can readily determine whether they satisfy independence requirements;
  2. the firm can maintain and update information relating to independence; and
  3. the firm and the engagement partner can take appropriate action regarding identified threats to independence.

.48 The firm should establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements and to enable it to take appropriate actions to resolve such situations. The policies and procedures should include requirements for

- personnel to promptly notify the firm of independence breaches of which they become aware.
- the firm to promptly communicate identified breaches of these policies and procedures and the required corrective actions to
  1. the engagement partner who, with the firm, has the responsibility to address the breach; and
  2. other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action.
- confirmation to the firm by the engagement partner and the other individuals referred to previously in subparagraph (b[2]) that the required corrective actions have been taken.

.49 At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by the requirements set forth in ET section 101 and its related interpretations and rulings of the AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies. Written confirmation may be in paper or electronic form.

.50 The purpose of obtaining confirmation and taking appropriate action on information indicating noncompliance is to demonstrate the importance that the firm attaches to independence and keep the issue current for and visible to its personnel.

.51 For all audit or attestation engagements where regulatory or other authorities require the rotation of personnel after a specified period, the firm’s policies and procedures should address these requirements.
Additional Guidance

.52 It is recommended that the auditor document all procedures discussed in this section in his or her working papers.

.53 International independence standards are established by the International Federation of Accountants’ (IFAC) International Ethics Standards Board for Accountants and can be found in section 290, Independence—Audit and Review Engagements, and section 291, Independence—Other Assurance Engagements, of the IFAC’s Code of Professional Ethics for Professional Accountants. The IFAC’s Code of Professional Ethics for Professional Accountants can be found at www.ifac.org/Guidance/EXD-Details.php?EDID=0116.

.54 For additional guidance practitioners may refer to the AICPA Audit Risk Alert Independence and Ethics Developments (AAM section 8240). This annual alert informs you of recent developments in the area of independence and ethics for members, including developments in international independence standards discussed previously in paragraph .52. Moreover, the alert helps you understand your independence requirements under the AICPA Code and, if applicable, certain other rule making and standard setting bodies. Also, the alert contains the AICPA Plain English Guide to Independence, which discusses the independence rules of the principal standard setting bodies in plain, straightforward English so you can understand and apply them with greater confidence and ease.

[The next page is 3181.]
AAM Section 3120

Understanding the Entity and Its Environment

General

.01 In accordance with the second standard of field work, “the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.” Obtaining an understanding of the entity and its environment is an essential aspect of performing an audit in accordance with generally accepted auditing standards. In particular, that understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment about assessing risks of material misstatement of the financial statements and responding to those risks throughout the audit, for example, when

- establishing materiality for planning purposes and evaluating whether that judgment remains appropriate as the audit progresses;
- considering the appropriateness of the selection and application of accounting policies and the adequacy of financial statement disclosures;
- identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management’s use of the going-concern assumption, complex or unusual transactions, or considering the business purpose of transactions;
- developing expectations for use when performing analytical procedures;
- designing and performing further audit procedures to reduce audit risk to an appropriately low level; and
- evaluating the sufficiency and appropriateness of audit evidence obtained, such as evidence related to the reasonableness of management’s assumptions and of management’s oral and written representations.

.02 The auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment, including its internal control. The auditor’s primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures. The depth of the overall understanding that the auditor obtains in performing the audit is less than that possessed by management in managing the entity.

.03 Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. Throughout this process, the auditor should also follow the guidance in AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1). See further discussion in AAM section 3145.

Risk Assessment Procedures

.04 Audit procedures performed to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels are referred to as risk assessment procedures. The auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels.
The auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

a. Inquiries of management and others within the entity

b. Analytical procedures

c. Observation and inspection

Risk assessment procedures are designed to gather and evaluate information about the client and are not specifically designed as substantive procedures or as tests of controls. Nevertheless, in performing risk assessment procedures, the auditor may obtain evidence about relevant assertions or the effectiveness of controls.

Inquiry of Management and Others

Although much of the information obtained by inquiry can be obtained from management, accounting personnel, and others involved in the financial reporting process, it is often helpful to direct inquiries to others within the entity. For example, people who work in production, sales, or internal audit, as well as individuals employed at different levels within the organization can provide a different perspective that helps identify risks of material misstatement. Inquiries of others can also help corroborate or provide additional details to the statements and representations made by management and accounting personnel. The following table provides examples of other individuals within the entity who might be able to help the auditor identify and assess the risk of material misstatement.

Examples of Inquires of Others Within the Entity

<table>
<thead>
<tr>
<th>Inquiries of these individuals (outside of management or the financial reporting process, or both)</th>
<th>May help the auditor understand</th>
</tr>
</thead>
</table>
| Those charged with governance | • the environment in which the financial statements are prepared.  
• whether they have knowledge of any fraud or suspected fraud.  
• how they exercise oversight of the entity’s programs and controls that address fraud.  
• their views on where the company is most vulnerable to fraud.  
• how financial statements are used. |
| Internal audit personnel | • the design and operating effectiveness of internal control.  
• internal audit activities related to internal control over financial reporting.  
• whether management has responded satisfactorily to internal audit findings.  
• their views on where the company is most vulnerable to fraud. |
| Employees involved in the initiation, processing, or recording of complex or unusual transactions | • the controls over the selection and application of accounting policies related to those transactions.  
• the business rationale for those transactions. |
### Analytical Procedures

.09 AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), specifies that the auditor should apply analytical procedures in planning the audit. The objective of these procedures is to help the auditor understand the client and its environment and, ultimately, to assess the risk of material misstatement. As such, the auditor may consider the analytical procedures performed during audit planning to be a risk assessment procedure that provides some broad audit evidence to support the opinion on the financial statements.

.10 Refer to paragraphs .06–.08 of AU section 329 for additional guidance on the performance of analytical procedures in planning the audit.

.11 The results of analytical procedures may help the auditor obtain an understanding of the entity. For example, analytical procedures may be helpful in identifying:

- the existence of unusual transactions or events, which may indicate the presence of significant risks, and
- amounts, ratios, and trends that might indicate matters that have financial statement and audit implications. For example, an unexpected amount, ratio, or trend may be the result of a misstatement that was not prevented or detected and corrected by the client’s system of internal control.
Observations and Inspection of Documents

.12 The auditor may use observation and the inspection of documents to support the responses received to the inquiries of management and others. Additionally, the observations and inspections will provide the auditor with further information about the entity and its environment that might not otherwise be obtained.

.13 The procedures performed to observe activities and inspect documents typically include the following:
- Observation of client activities and operations
- Visits to the client’s premises and plant facilities
- Inspection of documents, records, and internal control manuals
- Reading reports prepared by management (such as quarterly management reports and interim financial statements)
- Reading minutes of board of directors’ meetings and other documents prepared by those charged with governance and internal audit
- Tracing transactions through the financial reporting information system (walkthroughs)

A Mix of Procedures

.14 The auditor is not required to perform all the risk assessment procedures described previously for each aspect of the understanding described in the following section. However, all the risk assessment procedures should be performed by the auditor in the course of obtaining the required understanding.

Discussion Among the Audit Team

.15 The members of the audit team, including the auditor with final responsibility for the audit, should discuss the susceptibility of the entity’s financial statements to material misstatements. The objectives of this discussion are for team members to
- gain a better understanding of the potential for material misstatements of the financial statements resulting from fraud or error in the specific areas assigned to them, and
- understand how the results of the audit procedures they perform may affect other aspects of the audit, including the decisions about the nature, timing, and extent of further audit procedures.

.16 This discussion could be held concurrently with the discussion among the audit team that is specified by AU section 316 to discuss the susceptibility of the entity’s financial statements to material misstatement due to fraud. See AAM section 3145 for further discussion on fraud.

.17 Topics for audit team discussion include the following:
- Areas of significant audit risk
- Unusual accounting procedures used by the client
- Important control systems
- Significant IT applications and how the client’s use of IT may affect the audit
- Areas susceptible to management override of controls
- Materiality at the financial level and at the account level and tolerable misstatement
- How materiality will be used to determine the extent of testing
- The application of generally accepted accounting principles to the client’s facts and circumstances and in light of the entity’s accounting policies
The need to
- exercise professional skepticism throughout the engagement
- remain alert for information or other conditions that indicate that a material misstatement due to fraud or error may have occurred
- follow up rigorously on any indications of a material misstatement

.18 The auditor should exercise professional judgment to determine logistical matters relating to the audit discussion, such as who should participate, how and when the discussion should occur, and its extent. Key members of the audit team, including the auditor with final responsibility, should be involved in the discussion.

.19 When considering who should participate in the discussion, the auditor also may determine that an IT specialist or other individual possessing specialized skills is needed on the audit team and, therefore, include that individual in the discussion.

Understanding Specified Aspects of the Entity and Its Environment

.20 The auditor’s understanding of the entity and its environment consists of an understanding of the following aspects:

a. Industry, regulatory, and other external factors

b. Nature of the entity

c. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements

d. Measurement and review of the entity’s financial performance

e. Internal control, which includes the selection and application of accounting policies

.21 The nature, timing, and extent of the risk assessment procedures performed depend on the circumstances of the engagement, such as the size and complexity of the entity and the auditor’s experience with it. In addition, identifying significant changes in any of the previously mentioned aspects of the entity from prior periods is particularly important in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

Industry, Regulatory, and Other External Factors

.22 The auditor should obtain an understanding of relevant industry, regulatory, and other external factors. These factors include industry conditions, such as the competitive environment, supplier and customer relationships, and technological developments; the regulatory environment encompassing, among other matters, relevant accounting pronouncements, the legal and political environment, and environmental requirements affecting the industry and the entity; and other external factors, such as general economic conditions.

.23 The industry in which the entity operates may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (such as political, economic, social, technical, and competitive). For example, long term contracts may involve significant estimates of revenues and costs that give rise to risks of material misstatement of the financial statements. Similarly, regulations may specify certain financial reporting requirements for the industry in which the entity operates. In such cases, the auditor should consider whether the audit team includes members with sufficient relevant knowledge and experience. If management fails to comply with such regulations, its financial statements may be materially misstated.
Nature of the Entity

.24 The auditor should obtain an understanding of the nature of the entity. The nature of an entity refers to the entity’s operations, its ownership, governance, the types of investments that it is making and plans to make, the way that the entity is structured, and how it is financed. An understanding of the nature of an entity enables the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

Objectives and Strategies and Related Business Risks

.25 The auditor should obtain an understanding of the entity’s objectives and strategies, and the related business risks that may result in material misstatement of the financial statements. The entity conducts its business in the context of industry, regulatory, and other internal and external factors. To respond to these factors, the entity’s management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the operational approaches by which management intends to achieve its objectives. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity’s ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity’s business is also dynamic and the entity’s strategies and objectives change over time.

.26 Business risk is broader than the risk of material misstatement of the financial statements, although it includes the latter. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Usually management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraphs .76–.80 of AU section 314, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (AICPA, Professional Standards, vol. 1).

Measurement and Review of the Entity’s Financial Performance

.27 The auditor should obtain an understanding of the measurement and review of the entity’s financial performance. Performance measures and their review indicate to the auditor aspects of the entity’s performance that management and others consider to be important. Performance measures, whether external or internal, create pressures on the entity that, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Obtaining an understanding of the entity’s performance measures assists the auditor in considering whether such pressures result in management actions that may have increased the risks of material misstatement.

.28 Internally generated information used by management for this purpose may include key performance indicators (financial and nonfinancial); budgets; variance analysis; subsidiary information and divisional, departmental, or other level performance reports; and comparisons of an entity’s performance with that of competitors. External parties may also measure and review the entity’s financial performance. For example, external information, such as analysts’ reports and credit rating agency reports, may provide information useful to the auditor’s understanding of the entity and its environment. Such reports may be obtained from the entity being audited or from Web sites.

Internal Control

.29 Refer to AAM section 3125 for the discussion of internal control.

Documentation

.30 The auditor should document the key elements of the understanding obtained regarding each of the aspects of the entity and its environment, including each of the components of internal control (discussed in AAM section 3125) to assess the risks of material misstatement of the financial statements; the sources of
information from which the understanding was obtained; and the risk assessment procedures. See AAM section 6000 for additional discussion on audit documentation.

[The next page is 3201.]
AAM Section 3125

Understanding of Internal Control

Introduction

.01 Internal control is broadly defined as a process designed to provide reasonable assurance regarding the achievement of the entity’s objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations. Internal control is effected by those charged with governance, management, and other personnel.

.02 The previous definition reflects certain fundamental concepts that follow:

A process. Internal control is a process. It is not one event or circumstance, but a series of actions that permeate an entity’s activities. These actions are pervasive, and are inherent in the way management runs the business.

People. Internal control is effected by people. It is not accomplished by policy manuals and forms, but the people of an organization, what they do and say. People need to know their responsibilities and limits of authority.

Reasonable assurance. Internal control, no matter how well designed and operated, can provide only reasonable assurance to management and the board of directors regarding achievement of an entity’s objectives.

Achievement of objectives. Internal control is geared to the achievement of entity objectives. The definition of these objectives provides auditors with a useful framework for understanding and analyzing internal controls.

.03 Auditors should obtain an understanding of their client’s internal control during the planning phase of every audit. Paragraph .40 of AU section 314, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (AICPA, Professional Standards, vol. 1), states the following:

The auditor should obtain an understanding of the five components of internal control sufficient to assess the risk of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures.

.04 As a practical matter, the previous requirement raises the following questions:

• What constitutes a sufficient understanding? That is, what should an auditor know about the client’s internal control?

• How should an auditor obtain this understanding?

.05 This section provides answers to each of the previous questions.

What Auditors Should Understand About Internal Control

.06 A sufficient understanding of internal control means the following:

• The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented.
• This understanding is ordinarily limited to controls that pertain to the entity’s objective of preparing reliable financial statements for external purposes.

• That one objective can be broken into five components, and an auditor should obtain an understanding of each of the five components.

.07 Obtaining an understanding of controls is different from testing the operating effectiveness of controls. Obtaining an understanding of internal control involves evaluating the design of a control and determining whether it has been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements. Implementation of a control means that the control exists and that the entity is using it. The auditor should consider the design of a control in determining whether to consider its implementation. In contrast, the objective of testing the operating effectiveness of controls is to determine whether the controls, as designed, prevent or detect a material misstatement. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied. The auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.

.08 The Jones family owns and operates several neighborhood grocery stores in Anytown. On a monthly basis, the controller of Jones Grocery performs bank reconciliations for all the bank accounts. For planning purposes, the auditor of Jones Grocery should determine whether this control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements and determine whether the controller actually performs the reconciliations. Not testing, but identifying controls are a key part of audit planning.

.09 AU section 314 provides a framework to help auditors obtain their understanding of internal control. That framework is built on two basic concepts: objectives and components.

.10 Internal control is a process designed to provide reasonable assurance regarding the achievement of entity objectives. Entities generally have the following three objectives:

Financial reporting. This objective relates to the preparation of reliable published financial statements.

Operations. This objective relates to effective and efficient use of the entity’s resources.

Compliance. This objective relates to the entity’s compliance with applicable laws and regulations.

.11 The bank reconciliation performed by the Jones Grocery controller is an example of a control that relates primarily to the financial reporting objective. Jones also has an inventory tracking and management system that allows each store manager to track inventory levels and order new items before they stock-out. This control activity is part of the operations objective. Each store also has a small deli that prepares sandwiches and hot entrees. These food preparation activities must comply with state health laws and regulations, and Jones has policies in place to help ensure that those laws and regulations are met. Those policies are directed at the entity’s compliance objective.

.12 Ordinarily, relevant controls for an audit relate to the financial reporting objective. Controls relating to operations and compliance objectives that are not relevant to an effective audit need not be considered. It is a matter of the auditor’s professional judgment, as to the controls or combination of controls that may be assessed. However, as stated in paragraph .115 of AU section 314, for significant risks, to the extent the auditor has not already done so, the auditor should evaluate the design of the entity’s related controls, including relevant control activities and determine whether they have been implemented.

.13 The controls having to do with the ordering of inventory or compliance with state health laws and regulations are important to Jones Grocery, but ordinarily will not relate to the audit of the company’s financial statement. The auditor of Jones may wish to inquire and document these controls for client service or other purposes, but because these controls are not relevant to the audit, he or she is not required to do so.
However, if controls relating to operations and compliance objectives pertain to information the auditor evaluates or uses in applying auditing procedures, then they may be relevant to the audit.

For example, the financial reporting system may produce a sales report by inventory stock number for each sales region. If the auditor decided to use information from this report when auditing the proper valuation of inventory, he or she may consider obtaining an understanding of the following:

- Which transactions or classes of transactions are included in the report
- How significant accounting information about those transactions are entered into and flow through the financial reporting system
- The files that are processed
- The nature of processing involved in producing the report

Controls pertaining to detecting noncompliance with laws and regulations that may have a direct and material effect on the financial statements, such as controls over compliance with income tax laws and regulations used to determine the income tax provision, may be relevant to an audit.

Controls designed to prevent or detect misappropriations of assets may include controls relating to financial reporting and operations objectives. For example, use of a lockbox system for collecting cash or access controls, such as passwords that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, controls to prevent the excess use of materials in production generally are not relevant to a financial statement audit. An auditor’s responsibility to understand internal control is generally limited to those controls relevant to the reliability of financial reporting.

An objective is what an entity strives to achieve. But what is needed to achieve that objective?

AU section 314 provides a framework that separates each financial reporting objective into five components. These components represent what is needed to achieve the entity’s objectives. The components of internal control are briefly described as follows:

**Control environment.** The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

**Risk assessment.** An entity’s risk assessment process for financial reporting purposes is its identification, analysis, and management of risks relevant to the preparation of financial statements that are presented fairly in conformity with generally accepted accounting principles. For example, risk assessment may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions.

**Control activities.** Control activities are the policies and procedures that help ensure that management directives are carried out; for example, that necessary actions are taken to address risks that threaten the achievement of the entity’s objectives.

**Information and communication systems.** The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, authorize, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. The quality of system generated information affects management’s ability to make appropriate decisions in controlling the entity’s activities and to prepare reliable financial reports. Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting.

**Monitoring.** Monitoring is a process that assesses the quality of internal control performance over time.
Some control components, for example the control environment, will have a pervasive effect on the entity’s activities. Other components, for example control activities, will be directed primarily toward the achievement of one or more of the three objectives described in paragraph .10 in this section. Auditors are generally interested only in those components of internal control that have a pervasive effect on the entity and those that are directly related to the reliability of financial reporting.

This internal control framework, the relationship between an entity’s objectives and internal control components, is discussed in more detail in AAM section 4200.

The internal control framework described here and in AAM section 4200 is only a means to help auditors consider the effect of an entity’s internal control in an audit. An auditor’s primary concern is not the classification of a specific control into any particular component and related objective. Rather, an auditor’s primary concern is whether, and how, a specific control prevents or detects and corrects material misstatements in relevant assertions related to classes of transactions, account balances, or disclosures, rather than its classification into any particular component. Controls relevant to the audit are those that individually or in combination with others are likely to prevent or detect material misstatements in financial statement assertions. Such controls may exist in any of the five components.

Andrea Auditor audits Jones Grocery. As on all audits, she should obtain an understanding of internal control sufficient to assess the risks of material misstatement and design the nature, timing, and extent of further audit procedures. To achieve this, she organizes her inquiries and other procedures to understand each of the five components of internal control that relate to the financial reporting objective. As a result of performing her procedures, she discovers the client’s bank reconciliation procedures. Should a bank reconciliation be considered a control activity? What about the fact that someone follows up and investigates old or unusual reconciling items. Is that considered monitoring activity?

The issue of how to classify a particular control is irrelevant for Andrea’s purposes. As an auditor, her primary consideration is to understand how the bank reconciliations, whether individually or in combination with other controls, affect financial statement assertions relating to cash.

How an Auditor Obtains an Understanding of Internal Control

The auditor should obtain a sufficient understanding of internal control by performing risk assessment procedures (inquiries of management and others within the entity, analytical procedures, and observation and inspection) to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. Procedures to obtain audit evidence about the design and implementation of relevant controls may include inquiring of entity personnel, observing the application of specific controls, inspecting documents and reports, and tracing transactions through the information system relevant to financial reporting. Inquiry alone is not sufficient to evaluate the design of a control relevant to an audit and to determine whether it has been implemented.

Auditors might consider the types of misstatements that occurred in prior audits (for example, whether they were associated with accounting estimates, whether they were routine errors that resulted from a lack of control consciousness, or whether they resulted from lack of sufficient personnel). This knowledge of prior misstatements can help an auditor focus his or her inquiries on those areas and whether changes have been made to internal control to prevent those misstatements in the future.

In a continuing audit, the auditor may already have significant experience with and documentation of internal control. In these situations, this knowledge from previous audits allows the auditor to focus on system changes.

Jones Grocery purchased a commercially available software package for independent grocers. During 20X1, Jones installed the general ledger system and the cash receipts/disbursements and accounts payable modules. As part of performing her 20X1 audit, Andrea Auditor obtained an understanding of the software package and the modules that
were installed. For her 20X2 audit, Andrea should focus on changes made to the system since 20X1. For example, she might inquire about the installation of other modules (such as inventory) or updated versions of the software package.

.29 Some controls are documented in policy and procedure manuals, flowcharts, source documents, journals, and ledgers. In these cases, inspection of the documentation and inquiries of entity personnel may provide a sufficient understanding to assess the risks of material misstatement and design the nature, timing, and extent of further audit procedures.

.30 When Jones Grocery receives a bill, it is input directly into the accounts payable module of their software package. The computer generates an accounts payable aging and a cash requirements report that indicates when each bill should be paid. The accounts payable module interfaces with the general ledger system to automatically post and update the appropriate general ledger account whenever bills are received or paid. To obtain her understanding of the accounts payable system, Andrea performed a “walk-through.” She made inquiries of Jones personnel and obtained copies of bills and the reports generated by the computer. She “walked through” the example bills to see how they were included in the computer reports and how totals from those reports were posted to the general ledger. She also made inquiries related to the completeness assertion, that is, how does Jones ensure that all bills are entered into the system? Andrea observed the Jones employee performing those control procedures.

.31 Documentation may not be available for some controls. For example, the understanding of certain aspects of the control environment, such as management integrity, may be obtained through previous experience updated by inquiries of management and observation of their actions. Although documentation may not be available, the auditor is still responsible for documenting his or her understanding of the components of internal control.

Documenting the Understanding

.32 The auditor should document the key elements of the understanding obtained regarding each of the components of internal control, to assess the risks of material misstatement of the financial statements; the sources of information from which the understanding was obtained; and the risk assessment procedures. The form and extent of this documentation is influenced by the nature and complexity of the entity’s controls. For example, documentation of the understanding of internal control of a complex information system in which a large volume of transactions are electronically initiated, authorized, recorded, processed, or reported may include flowcharts, questionnaires, or decision tables. For an information system making limited or no use of IT or for which few transactions are processed (for example, long-term debt), documentation in the form of a memorandum may be sufficient. Generally, the more complex the entity’s internal control and the more extensive the procedures performed by the auditor, the more extensive the auditor should document his or her work.

[The next page is 3221.]
AAM Section 3130

Assessing the Risks of Material Misstatement

General

.01 Knowledge an auditor acquires about a client encompasses a broad range of information, including the following:

- Industry, regulatory, and other external factors affecting the client
- The nature of the client, including its operations and organizational structure
- The client’s objectives, strategies, and related business risks, some of which will give rise to risks affecting the financial statements
- How management measures and reviews the company’s financial performance
- An understanding of the internal controls that are in use at the entity, including an understanding of the use of IT and the controls designed and used within the IT system

This knowledge of a client forms the basis for identifying risks and evaluating how these risks could result in financial statement misstatements.

.02 The auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. For this purpose, the auditor should

- identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and considering the classes of transactions, account balances, and disclosures in the financial statements.
- relate the identified risks to what can go wrong at the relevant assertion level.
- consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements.
- consider the likelihood that the risks could result in a material misstatement of the financial statements.

.03 The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the risk assessment to determine the nature, timing, and extent of further audit procedures to be performed. When the risk assessment is based on an expectation that controls are operating effectively to prevent or detect material misstatement, individually or when aggregated, at the relevant assertion level, the auditor should perform tests of the controls that the auditor has determined to be suitably designed to prevent or detect a material misstatement in the relevant assertion to obtain audit evidence that the controls are operating effectively, as described in AU section 318, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (AICPA, Professional Standards, vol. 1).

.04 The auditor should determine whether the identified risks of material misstatement relate to specific relevant assertions related to classes of transactions, account balances, and disclosures, or whether they relate more pervasively to the financial statements taken as a whole and potentially affect many relevant assertions.
Financial Statement Assertions

.05 Paragraphs .14–.19 of AU section 326, Audit Evidence (AICPA, Professional Standards, vol. 1), discuss the use of assertions in obtaining audit evidence. In representing that the financial statements are fairly presented in accordance with generally accepted accounting procedures, management implicitly or explicitly makes assertions regarding the recognition, measurement, and disclosure of information in the financial statements and related disclosures. Assertions used by the auditor fall into the following categories:
<table>
<thead>
<tr>
<th>Categories of Assertions</th>
<th>Description of Assertions</th>
<th>Classes of transactions and events during the period</th>
<th>Occurrence/Existence</th>
<th>Rights and Obligations</th>
<th>Completeness</th>
<th>Accuracy/valuation and allocation</th>
<th>Cut-off</th>
<th>Classification and understandability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cut-off</td>
<td>Transactions and events have been recorded in the correct accounting period.</td>
<td>Transactions and events have been recorded in the correct accounting period.</td>
<td>Transactions and events have been recorded.</td>
<td>All transactions and events that should have been recorded have been recorded.</td>
<td>Amounts and other data relating to recorded transactions and events have been recorded appropriately.</td>
<td>Financial and other information disclosed fairly and at appropriate amounts.</td>
<td>Financial information is appropriately presented and described, and information in disclosures is expressed clearly.</td>
<td>Financial information is appropriately presented and described, and information in disclosures is expressed clearly.</td>
</tr>
</tbody>
</table>
The auditor should use relevant assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor should use relevant assertions in assessing risks by considering the different types of potential misstatements that may occur, and then designing further audit procedures that are responsive to the assessed risks.

Assessing Risks at the Financial Statement Level

Risks of material misstatement at the financial statement level are those risks that relate pervasively to the financial statements and potentially affect many individual assertions. Risks at the financial statement level may derive in particular from a weak control environment. The nature of the risks arising from a weak control environment is such that they are not likely to be confined to specific individual risks of material misstatement in particular classes of transactions, account balances, and disclosures. Rather, weaknesses such as management’s lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

Characteristics of financial statement level risks that are relevant for audit purposes include the following:

- **Financial statement level risks can affect many assertions.** By definition, financial statement level risks may result in material misstatements of several accounts or assertions. For example, a lack of controls over journal entries increases the risk that an inappropriate journal entry could be posted to the general ledger as part of the period-end financial reporting process. The posting of an inappropriate journal entry may not be isolated to one general ledger account but potentially could affect any account. In general, overall audit risk increases when the magnitude or scope of an identified risk of misstatement is not known.

- **Assessing financial statement level risks requires significant judgment.** Ultimately, the auditor should relate identified risks of misstatement to what can go wrong. For example, suppose that while performing risk assessment procedures to gather information about the control environment, the auditor discovered weaknesses relating to the hiring, training, and supervision of entity personnel. These weaknesses result in an increased risk of a misstatement of the financial statements, but it will be a matter of the auditor’s professional judgment to determine the following:
  - The accounts and relevant assertions that could be affected
  - The likelihood that a financial statement misstatement will result from the increased risk
  - The significance of any misstatement

- **Risks at the financial statement level may not be identifiable with specific assertions.** Control weaknesses at the financial statement level can render well designed activity level controls ineffective. For example, a significant risk of management override can potentially negate existing controls and procedures at the activity level in many accounts and for many assertions. Linking such a risk to specific accounts and assertions may be very difficult, and may not even be possible. As another example, a client may have excellent data input controls at the application level. But if poorly designed, IT general controls may allow many unauthorized personnel the opportunity to access and inappropriately change the data and the well designed input controls will be rendered ineffective. Also, strengths in financial statement level controls such as an overall culture of ethical behavior may increase the reliability of controls that operate at the activity level. Determining the extent to which financial statement level controls affect the reliability of specific activity level controls (and therefore the assessment of the risks of material misstatement) is subjective and may vary from client to client.
Assessing Risks at the Assertion Level

.09 In making risk assessments, the auditor should identify the controls that are likely to prevent or detect and correct material misstatements in specific relevant assertions. Generally, the auditor gains an understanding of controls and relates them to relevant assertions in the context of processes and systems in which they exist. Doing so is useful because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other elements of internal control, will be sufficient to address a risk.

.10 Conversely, some control activities may have a specific effect on an individual relevant assertion embodied in a particular class of transaction or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence and completeness assertions for the inventory account balance.

.11 Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing or detecting and correcting misstatements in that assertion. For example, a sales manager’s review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

Significant Risks That Require Special Audit Consideration

.12 As part of the assessment of the risks of material misstatement, the auditor should determine which of the risks identified are, in the auditor’s judgment, risks that require special audit consideration (such risks are defined as significant risks). One or more significant risks normally arise on most audits. In exercising this judgment, the auditor should consider inherent risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration. AU section 314, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (AICPA, Professional Standards, vol. 1), establishes standards and provides guidance to the auditor in determining whether any of the assessed risks are significant risks that require special audit consideration or risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. The auditor should evaluate the design of the entity’s controls, including relevant control activities, over such risks and determine whether they are adequate and have been implemented. Paragraphs .45 and .53 of AU section 318 describe the consequences for further audit procedures of identifying risks as significant.

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence

.13 As part of the risk assessment previously described in paragraph .12, the auditor should evaluate the design and determine the implementation of the entity’s controls, including relevant control activities, over those risks for which, in the auditor’s judgment, it is not possible or practicable to reduce detection risk at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures. The consequences for further audit procedures of identifying such risks are described in paragraph .24 of AU section 318.

Revision of Risk Assessment

.14 The auditor’s assessment of the risks of material misstatement at the relevant assertion level is based on available audit evidence and may change during the course of the audit as additional audit evidence is obtained. In particular, the risk assessment may be based on an expectation that controls are operating effectively to prevent or detect and correct a material misstatement at the relevant assertion level. In
performing tests of controls to obtain audit evidence about their operating effectiveness, the auditor may obtain audit evidence that controls are not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures, the auditor may detect misstatements in amounts or frequency that is greater than is consistent with the auditor’s risk assessment. When the auditor obtains audit evidence from performing further audit procedures that tends to contradict the audit evidence on which the auditor originally based the assessment, the auditor should revise the assessment and should further modify planned audit procedures accordingly. See paragraphs .70 and .74 of AU section 318 for further guidance.

Documentation

.15 The auditor should document (a) the assessment of the risks of material misstatement both at the financial statement level and at the relevant assertion level and the basis for the assessment and (b) the risks identified and related controls evaluated as a result of the requirements for significant risks.

[The next page is 3271.]
AAM Section 3140

Audit Risk and Materiality

General

.01 Audit risk and materiality, among other matters, need to be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures. The existence of audit risk is recognized in the description of the responsibilities and functions of the independent auditor. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. In other words, audit risk is the risk that the auditor will issue an unqualified opinion on financial statements that are materially incorrect.

.02 Financial statements are materially misstated when they contain misstatements whose effect, individually or in the aggregate, are important enough to cause them not to be presented fairly, in all material respects, in conformity with generally accepted accounting principles (GAAP). Materiality is the criterion used by auditors to distinguish between unimportant and important matters. The auditor’s consideration of materiality is a matter of professional judgment and is influenced by a perception of the needs of users of the financial statements. The perceived needs of users are recognized in the discussion of materiality in FASB Concepts Statement No. 2, Qualitative Characteristics of Accounting Information, which defines materiality as

The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

Nature and Causes of Misstatements

.03 The representation in the auditor’s standard report regarding fair presentation, in all material respects, in conformity with generally accepted accounting principles indicates the auditor’s belief that the financial statements, taken as a whole, are not materially misstated. Misstatements can result from errors or fraud.1 and may consist of any of the following:

a. An inaccuracy in gathering or processing data from which financial statements are prepared

b. A difference between the amount, classification, or presentation of a reported financial statement element, account, or item and the amount, classification, or presentation that would have been reported under GAAP

c. The omission of a financial statement element, account, or item

d. A financial statement disclosure that is not presented in conformity with GAAP

e. The omission of information required to be disclosed in conformity with GAAP

f. An incorrect accounting estimate arising, for example, from an oversight or misinterpretation of facts

g. Management’s judgments concerning an accounting estimate or the selection or application of accounting policies that the auditor may consider unreasonable or inappropriate

1 The auditor’s consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in AU section 317, Illegal Acts by Clients (AICPA, Professional Standards, vol. 1). See AAM section 3150, Illegal Acts. For those illegal acts that are defined in that statement as having a direct and material effect on the determination of financial statement amounts, the auditor’s responsibility to detect misstatements resulting from such illegal acts if the same as that for errors or fraud.
Misstatements may be of two types: known and likely, defined as follows:

**Known misstatements.** These are specific misstatements identified during the audit arising from the incorrect selection or misapplication of accounting principles or misstatements of facts identified, including, for example, those arising from mistakes in gathering or processing data and the overlooking or misinterpretation of facts.

**Likely misstatements.** These are misstatements that

- arise from differences between management’s and the auditor’s judgments concerning accounting estimates that the auditor considers unreasonable or inappropriate (for example, because an estimate included in the financial statements by management is outside of the range of reasonable outcomes the auditor has determined).
- the auditor considers likely to exist based on an extrapolation from audit evidence obtained (for example, the amount obtained by projecting known misstatements identified in an audit sample to the entire population from which the sample was drawn).

The term *errors* refers to unintentional misstatements of amounts or disclosures in financial statements. The term *fraud* refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Two types of misstatements resulting from fraud are relevant to the auditor’s consideration in a financial statement audit: misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. These two types of misstatements are further described in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, Professional Standards, vol. 1).

See AAM section 3145 for a further discussion on fraud.

Although the auditor has no responsibility to plan and perform the audit to detect immaterial misstatements, there is a distinction in the auditor’s response to detected misstatements depending on whether those misstatements are caused by error or fraud. When the auditor encounters evidence of potential fraud, regardless of its materiality, the auditor should consider the implications for the integrity of management or employees and the possible effect on other aspects of the audit.

**Considerations at the Financial Statements Level**

The auditor must consider audit risk and must determine a materiality level for the financial statements taken as a whole for the purpose of

- determining the extent and nature of risk assessment procedures.
- identifying and assessing the risks of material misstatement.
- determining the nature, timing, and extent of further audit procedures.
- evaluating whether the financial statements taken as a whole are presented fairly, in all material respects, in conformity with GAAP.

Audit risk is a function of the risk that the financial statements prepared by management are materially misstated and the risk that the auditor will not detect such material misstatement. The auditor should consider audit risk in relation to the relevant assertions related to individual account balances, classes of transactions, and disclosures and at the overall financial statement level. The auditor should perform risk assessment procedures to assess the risks of material misstatement both at the financial statement and the relevant assertion levels. The auditor may reduce audit risk by determining overall responses and designing the nature, timing, and extent of further audit procedures based on those assessments.
.10 The auditor should perform the audit to reduce audit risk to a low level that is, in the auditor’s professional judgment, appropriate for expressing an opinion on the financial statements. Audit risk may be assessed in quantitative or nonquantitative terms.

.11 The considerations of audit risk and materiality are affected by the size and complexity of the entity and the auditor’s experience with and knowledge of the entity and its environment, including its internal control. As discussed in the following heading, “Considerations at the Individual Account Balance, Class of Transactions, or Disclosure Level,” certain entity related factors also affect the nature, timing, and extent of further audit procedures with respect to relevant assertions related to specific account balances, classes of transactions, and disclosures.

.12 In considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. Risks of this nature often relate to the entity’s control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. Such risks may be especially relevant to the auditor’s consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control. In developing responses to the risks of material misstatement at the overall financial statement level, the auditor should consider such matters as the knowledge, skill, and ability of personnel assigned significant engagement responsibilities; whether certain aspects of the engagement need the involvement of a specialist; and the appropriate level of supervision of assistants.

Considerations at the Individual Account Balance, Class of Transactions, or Disclosure Level

.13 In determining the nature, timing, and extent of audit procedures to be applied to a specific account balance, class of transactions, or disclosure, the auditor should design audit procedures to obtain reasonable assurance of detecting misstatements that the auditor believes, based on the judgment about materiality, could be material, when aggregated with misstatements in other balances, classes, or disclosures, to the financial statements taken as a whole.

.14 The auditor should consider audit risk at the individual account balance, class of transactions, or disclosure level because such consideration directly assists in determining the nature, timing, and extent of further audit procedures for the relevant assertions related to balances, classes, or disclosures. The auditor should seek to reduce audit risk at the individual balance, class, or disclosure level in such a way that will enable the auditor, at the completion of the audit, to express an opinion on the financial statements taken as a whole at an appropriately low level of audit risk.

.15 At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of (a) the risk (consisting of inherent risk and control risk) that the relevant assertions related to balances, classes, or disclosures contain misstatements (whether caused by error or fraud) that could be material to the financial statements when aggregated with misstatements in other relevant assertions related to balances, classes, or disclosures and (b) the risk (detection risk) that the auditor will not detect such misstatements. These components of audit risk may be assessed in quantitative terms, such as percentages, or in nonquantitative terms such as high, medium, or low risk. The way the auditor should consider these component risks and combines them involves professional judgment and depends on the auditor’s approach or methodology.

.16 Inherent risk is the susceptibility of a relevant assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related account balances, classes of transactions, and disclosures than for others. For example, complex calculations are more likely to be misstated than simple calculations. Cash is more susceptible to theft than an inventory of coal. Accounts consisting of amounts derived from accounting estimates that are subject to significant measurement uncertainty pose greater risks than do accounts consisting of relatively routine, factual data. External circumstances giving rise to business risks also influence inherent risk. For example, technological developments might make a particular product
obsolete, thereby causing inventory to be more susceptible to overstatement. In addition to those circumstances that are peculiar to a specific relevant assertion, factors in the entity and its environment that relate to several or all of the classes of transaction, account balances, or disclosures may influence the inherent risk related to a specific relevant assertion. These latter factors include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.

.17 Control risk is the risk that a misstatement that could occur in a relevant assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected on a timely basis by the entity’s internal control. That risk is a function of the effectiveness of the design and operation of internal control in achieving the entity’s objectives relevant to preparation of the entity’s financial statements. Some control risk will always exist because of the inherent limitations of internal control.

.18 Inherent risk and control risk are the entity’s risks, that is, they exist independently of the audit of financial statements. AU section 312, Audit Risk and Materiality in Conducting an Audit (AICPA, Professional Standards, vol. 1), and other AU sections describe the risk of material misstatement as the auditor’s combined assessment of inherent risk and control risk; however, the auditor may make separate assessments of inherent risk and control risk. Furthermore, auditors may implement the concepts surrounding the assessment of inherent and control risks and responding to the risk of material misstatement in different ways as long as they achieve the same result.

.19 The auditor should assess the risk of material misstatement at the relevant assertion level as a basis for further audit procedures. Although that assessment is a judgment rather than a precise measurement of risk, the auditor should have an appropriate basis for that assessment. This basis may be obtained through the risk assessment procedures performed to obtain an understanding of the entity and its environment, including its internal control, and through the performance of suitable tests of controls to obtain audit evidence about the operating effectiveness of controls, where appropriate.

.20 Detection risk is the risk that the auditor will not detect a misstatement that exists in a relevant assertion that could be material, either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. Detection risk cannot be reduced to zero because the auditor does not examine 100 percent of an account balance or a class of transactions and because of other factors. Such other factors include the possibility that an auditor might select an inappropriate audit procedure; misapply an appropriate audit procedure; or misinterpret the audit results. These other factors might be addressed through adequate planning; proper assignment of personnel to the engagement team; the application of professional skepticism, supervision, and review of the audit work performed; and supervision and conduct of a firm’s audit practice in accordance with appropriate quality control standards. Detection risk can be disaggregated into additional components of tests of details risk and substantive analytical procedures risk.

.21 Detection risk relates to the substantive audit procedures and is managed by the auditor’s response to risk of material misstatement. For a given level of audit risk, detection risk should bear an inverse relationship to the risk of material misstatement at the relevant assertion level. The greater the risk of material misstatement, the less the detection risk that can be accepted by the auditor. Conversely, the lower the risk of material misstatement, the greater the detection risk that can be accepted by the auditor. However, the auditor should perform substantive procedures for all relevant assertions related to material classes of transactions, account balances, and disclosures.

Materiality

.22 The auditor’s consideration of materiality is a matter of professional judgment and is influenced by the auditor’s perception of the needs of users of financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.
Determining Materiality for the Financial Statements Taken as a Whole When Planning the Audit

.23 The auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall audit strategy for the audit. Determining a materiality level for the financial statements taken as a whole helps guide the auditor’s judgments in identifying and assessing the risks of material misstatements and in planning the nature, timing, and extent of further audit procedures. This materiality level does not, however, establish a threshold below which identified misstatements are always considered to be immaterial when evaluating those misstatements and their effect on the financial statements and the auditor’s report thereon.

.24 The auditor often may apply a percentage to a chosen benchmark as a step in determining materiality for the financial statements taken as a whole. When identifying an appropriate benchmark, the auditor may consider factors such as the following:

- The elements of the financial statements (for example, assets, liabilities, equity, income, and expenses) and the financial statement measures defined in GAAP (for example, financial position, financial performance, and cash flows), or other specific requirements
- Whether there are financial statement items on which, for the particular entity, users’ attention tends to be focused (for example, for the purpose of evaluating financial performance)
- The nature of the entity and the industry in which it operates
- The size of the entity, nature of its ownership, and the way it is financed

Examples of benchmarks that might be appropriate, depending on the nature and circumstances of the entity, include total revenues, gross profit, and other categories of reported income, such as profit before tax from continuing operations. Profit before tax from continuing operations may be a suitable benchmark for profit oriented entities but may not be an appropriate benchmark for the determination of materiality when, for example, the entity’s earnings are volatile, when the entity is a not-for-profit entity, or when it is an owner managed business where the owner takes much of the pretax income out of the business in the form of remuneration. For asset based entities (for example, an investment fund) an appropriate benchmark might be net assets. Other entities (for example, banks and insurance companies) might use other benchmarks.

.25 When determining materiality, the auditor should consider prior periods’ financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, taking account of significant changes in the entity’s circumstances (for example, a significant business acquisition) and relevant changes of conditions in the economy as a whole or the industry in which the entity operates.

.26 Once materiality is established, the auditor should consider materiality when planning and evaluating the same way regardless of the inherent business characteristics of the entity being audited.

Tolerable Misstatement

.27 The initial determination of materiality is made for the financial statement taken as a whole. However, the auditor should allow for the possibility that some misstatements of lesser amounts than the materiality levels could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor should determine one or more levels of tolerable misstatement. Tolerable misstatement (or tolerable error) is the maximum error in a population (for example, the class of transactions or account balance) that the auditor is willing to accept. Such levels of tolerable misstatement are normally lower than the materiality levels.

Qualitative Aspects of Materiality

.28 As indicated previously, judgments about materiality include both quantitative and qualitative information. As a result of the interaction of quantitative and qualitative considerations in materiality judgments,
misstatements of relatively small amounts that come to the auditor’s attention could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

.29 Qualitative considerations also influence the auditor in reaching a conclusion about whether misstatements are material. Paragraph .60 of AU section 312 provides qualitative factors that the auditor may consider relevant in determining whether misstatements are material.

Considerations as the Audit Progresses

.30 Because it is not feasible for the auditor to anticipate all the circumstances that may ultimately influence judgments about materiality in evaluating the audit findings at the completion of the audit, the auditor’s judgment about materiality for planning purposes may differ from the judgment about materiality used in evaluating the audit findings.

.31 If the auditor concludes that a lower materiality level than that initially determined is appropriate, the auditor should reconsider the related levels of tolerable misstatement and appropriateness of the nature, timing, and extent of further audit procedures. The auditor should consider whether the overall audit strategy and audit plan need to be revised if the nature of identified misstatements and the circumstances of their occurrence are indicative that other misstatements may exist that, when aggregated with identified misstatements, could be material. The auditor should not assume that a misstatement is an isolated occurrence.

.32 If the aggregate of the misstatements (known and likely) that the auditor has identified approaches the materiality level, the auditor should consider whether there is a greater than acceptably low level of risk that undetected misstatements, when taken with the aggregate identified misstatements, could exceed the materiality level and, if so, the auditor should reconsider the nature and extent of further audit procedures.

Quantifying Materiality

.33 Although no authoritative body has established specific guidelines for materiality, there are certain rules of thumb that can be used in making a preliminary assessment of materiality.

.34 Generally, materiality guidelines are relative rather than absolute. In other words, materiality is usually set as a percentage rather than as an absolute amount. For example, an absolute amount such as $100,000 may be immaterial to a large, multinational corporation but very material to a small, closely held company. To apply percentage guidelines, auditors determine what base to use. Generally, auditors select a base that is relatively stable and predictable. Bases commonly used include income before taxes, revenues, and total assets. Generally, misstatements become material to income before they become material to the balance sheet. As a consequence, net income before taxes is often selected as the base.

.35 In small business audits, auditors sometimes make a number of significant audit adjustments. Thus, income before taxes may vary too much to be useful as a base. When income before taxes is not used as a base, auditors sometimes use either total revenue or an average of net income for several prior periods.

Example

.36 A common rule of thumb for materiality is 5 percent to 10 percent of pretax income (for profit-orientated entities). Some auditors apply this rule of thumb so that items less than 5 percent of normal pretax income are considered immaterial, whereas items that are more than 10 percent are material. For items between 5 percent to 10 percent, judgment is applied. For example, when unusual factors exist (perhaps the company is about to be sold for a multiple of audited earnings) auditors would tend to classify items between 5 percent and 10 percent as material. Others use 1 percent or 1.5 percent of the larger of total assets or revenues. (See exhibit 1 for a sample planning materiality worksheet.) Note that a percentage of pretax income may not be an appropriate benchmark for the determination of materiality when, for example, the entity’s earnings are
volatile, when the entity is a not-for-profit entity, or when the owner takes much of the pretax income out of the business in the form of remuneration.

**Exhibit 1**

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<thead>
<tr>
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<th>Initials</th>
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<tr>
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Client Name
Planning Materiality Worksheet
Balance Sheet Date

1. Unaudited total assets at balance sheet date
2. Unaudited total revenues at balance sheet date
3. Select the larger of line 1 or line 2
4. Select a multiplier if audit risk is normal, or, if better than normal, select .01
5. Multiply line 3 by line 4
6. Unaudited pretax income (or equivalent if not a for-profit entity)
7. Select a multiplier if audit risk is normal, or, if better than normal, select .1
8. Multiply line 6 by line 7
9. Evaluate line 5 and line 8 along with other relevant factors and determine materiality for audit planning purposes

.37 Consideration of which base to use may include such factors as income variability and the nature of the client’s business and industry. For a not-for-profit organization, for example, the auditor would probably use total assets or revenues as a base because pretax income is not meaningful.

**SEC Staff Bulletin on Materiality for SEC Registrants**

.38 Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 99, *Materiality*, addresses the application of materiality thresholds to the preparation and audit of financial statements filed with the SEC. The SAB does not create new standards or definitions for materiality, but reaffirms the concepts of materiality as expressed in the accounting and auditing literature, as well as in long standing case law.

.39 SAB No. 99 states that registrants and the auditors of their financial statements cannot rely exclusively on quantitative benchmarks to determine whether an item is material to the financial statements. Equally important is a consideration of whether, in light of the surrounding circumstances, a reasonable investor would consider the item to be important. The SAB also states that management should not make intentional immaterial errors in a registrant’s financial statements to “manage” earnings. It further reminds registrants of their legal responsibility to make and keep books, records, and accounts that, in reasonable detail, accurately and fairly reflect transactions and the disposition of assets. The SAB reminds auditors of their obligations to inform management and, in some cases, audit committees of illegal acts that come to the auditor’s attention. The full text of the SAB can be viewed at the SEC Web site at www.sec.gov/interp/account/sab99.htm.
Communication of Misstatements to Management

.40 The auditor must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial,2 and communicate them to the appropriate level of management. This communication should occur on a timely basis.

.41 When communicating details of misstatements, the auditor should distinguish between known misstatements and likely misstatements. The auditor should request management to record the adjustment needed to correct all known misstatements, including the effect of prior period misstatement, other than those that the auditor believes are trivial.

.42 If management decides not to correct some or all of the known and likely misstatements communicated to it by the auditor or identified when management examined a class of transactions, account balance, or disclosure, the auditor should obtain an understanding of management’s reasons for not making the corrections and should take that into account when considering the qualitative aspects of the entity’s accounting practices and the implications for the auditor’s report.

Evaluating Audit Findings

.43 In evaluating whether the financial statements are presented fairly, in all material respects, in conformity with GAAP, the auditor must consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity. In making this evaluation, in relation to particular classes of transactions, account balances, and disclosures, the auditor should consider the size and nature of the misstatements and the particular circumstances of their occurrence and determine the effect of such misstatements on the financial statements taken as a whole.

.44 In aggregating misstatements, the auditor should include the effect on the current period’s financial statements of those prior period misstatements. When evaluating the aggregate uncorrected misstatements, the auditor should consider the effects of these uncorrected misstatements in determining whether the financial statements are free of material misstatement.

.45 In evaluating the effects of misstatements, the auditor should include both qualitative and quantitative materiality considerations (see paragraphs .59–.60 of AU section 312). Qualitative considerations also influence the auditor in reaching a conclusion as to whether misstatements are material.

Likely Misstatements

.46 The auditor’s best estimate of the total misstatements in the account balances or classes of transactions that he or she has examined is referred to as likely misstatements.

.47 When the auditor tests an account balance or a class of transactions and related assertions by an analytical procedure, he or she might not specifically identify misstatements but would only obtain an indication of whether a misstatement might exist in the balance or class and possibly its approximate magnitude. If the analytical procedure indicates that a misstatement might exist, but not its approximate amount, the auditor should request management to investigate and, if necessary, should expand his or her audit procedures to enable him or her to determine whether a misstatement exists in the account balance or class or transactions.

.48 When an auditor uses audit sampling to test an assertion for an account balance or a class of transactions, he or she projects the amount of known misstatements identified in the sample to the items in the balance or class from which the sample was selected. For example, if a $1,000 loan receivable misstatement is found in a sample of 10 percent of the population, the projected misstatement would be $10,000.

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2 Matters that are “trivial” are amounts designated by the auditor below which misstatements need not be accumulated. This amount is set so that any such misstatements, either individually or when aggregated with other such misstatements, would not be material to the financial statements after the possibility of further undetected misstatements is considered.
projected misstatement, along with the results of other substantive procedures, contributes to the auditor’s assessment of likely misstatement in the account balance or class of transactions.

.49 When auditing accounting estimates (for example, allowance for inventory obsolescence, allowance for doubtful accounts, or warranty obligations) the audit evidence gathered may support an amount for an estimate different from the amount the client has recorded. That difference may be considered reasonable by the auditor inasmuch as no one accounting estimate can be considered accurate with certainty. In that case, the difference between the estimate that the audit evidence supports and the estimate recorded in the financial statements would not be considered a likely misstatement. However, if the auditor believes the estimated amount included in the financial statements is unreasonable, he or she should treat the difference between that estimate and the closest reasonable estimate as a likely misstatement.

Known Misstatements

.50 Known misstatements are those for which the amount of the misstatements are specifically identified. Such misstatements are often supported by highly reliable evidence, such as third party documents. An example of a known misstatement would be a failure to record an invoice for repairs expense.

Misstatements From the Prior Year

.51 Often overlooked is the consideration of misstatements detected in the prior year that affect the current year. For example, assume last year’s aggregation of uncorrected misstatements included an item representing an overstatement of prepaid insurance and an understatement of insurance expense. This item would be included in the current year’s aggregation of uncorrected misstatements because it affects the current year’s insurance expense. Therefore, the prior year’s aggregation of uncorrected misstatements should be reviewed for any items that may have an effect on the current year’s financial statements.

Summarizing and Evaluating Misstatements

.52 Most firms prepare a summary of the uncorrected misstatements identified during the audit. This summary may be called the Summary of Misstatements, or the Summary of Possible Journal Entries, or other names. The summary presents known, likely, and prior period misstatements separately. The summary is used in evaluating the effect of uncorrected misstatements on the financial statements at the end of the audit.

.53 Some firms establish a predetermined dollar threshold below which misstatements need not be accumulated. This amount may be set so that any such misstatements, either individually, or when aggregated with other such misstatements, would not be material to the financial statements after the possibility of further undetected misstatements is considered.

.54 When concluding as to whether the effect of misstatements, individually or in the aggregate, is material, an auditor should consider the nature and amount of the misstatements in relation to the nature and amount of items in the financial statements under audit.

.55 If the auditor believes that the financial statements taken as a whole are materially misstated, the auditor should request management to make the necessary corrections. If management refuses to make the corrections, the auditor must determine the implications for the auditor’s report.

.56 If the auditor concludes that the effects of uncorrected misstatements, individually or in the aggregate, do not cause the financial statements to be materially misstated, they could still be materially misstated because of further misstatements remaining undetected. As the aggregate misstatements approach materiality, the risk that the financial statements may be materially misstated also increases; consequently, the auditor should also consider the effect of undetected misstatements in concluding whether the financial statements are fairly stated.
In addition to the documentation requirements in AU section 339, Audit Documentation (AICPA, Professional Standards, vol. 1), AU section 312 states the auditor should document the following:

a. The levels of materiality, as discussed in paragraph .27 of AU section 312, and tolerable misstatement, including any changes thereto, used in the audit and the basis on which those levels were determined.

b. A summary of uncorrected misstatements, other than those that are trivial, related to known and likely misstatements.

c. The auditor’s conclusion as to whether uncorrected misstatements, individually or in aggregate, do or do not cause the financial statements to be materially misstated, and the basis for that conclusion.

d. All known and likely misstatements identified by the auditor during the audit, other than those that are trivial, that have been corrected by management.

Uncorrected misstatements should be documented in a manner that allows the auditor to:

a. separately consider the effects of known and likely misstatements, including uncorrected misstatements identified in prior periods.

b. consider the aggregate effect of misstatements on the financial statements.

c. consider the qualitative factors that are relevant to the auditor’s consideration whether misstatements are material (see paragraph .60 of AU section 312).

[The next page is 3291.]
AAM Section 3145

Fraud

General

.01 AU section 110, Responsibilities and Functions of the Independent Auditor (AICPA, Professional Standards, vol. 1), states that “The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.” Management is responsible for the design and implementation of programs and controls to prevent, deter, and detect fraud. That responsibility is described in paragraph .03 of AU section 110.

.02 An auditor’s responsibilities relating to fraud are stated within the context of materiality to the financial statements taken as a whole. An auditor is not responsible for detecting fraud per se, but for obtaining reasonable assurances that material misstatements due to fraud are detected. An auditor is not responsible for detecting immaterial misstatements caused by fraud. Paragraph .03 of AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), states that the requirements and guidance set forth in AU section 316 are intended to be integrated into the overall audit process in a logical manner that is consistent with the requirements and guidance provided in other AU sections, including AU section 311, Planning and Supervision; AU section 312, Audit Risk and Materiality in Conducting an Audit; AU section 314, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement, and AU section 318, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (AICPA, Professional Standards, vol. 1). AU section 316 describes a process in which the auditor

- exercises professional skepticism,
- discusses the risks of material misstatements due to fraud with engagement personnel,
- gathers information needed to identify risks of material misstatement due to fraud,
- identifies risks that may result in a material misstatement due to fraud,
- assesses the identified risks after taking into account an evaluation of the entity’s programs and controls that address the risks,
- responds to the results of the assessment,
- evaluates audit evidence,
- communicates about fraud to management, those charged with governance, and others, and
- documents the auditor’s consideration of fraud.

.03 Even though some requirements and guidance set forth in AU section 316 are presented in a manner that suggests a sequential audit process, auditing, in fact, involves a continuous process of gathering, updating, and analyzing information throughout the audit. Accordingly, the sequence of the requirements and guidance in AU section 316 may be implemented differently among audit engagements.

Description and Characteristics of Fraud

.04 The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement in financial statements is intentional or unintentional. Paragraph .05 of AU section 316 defines fraud as an intentional act that results in a material misstatement in financial statements that are the subject of an audit.
Three conditions generally are present when fraud occurs. First, management or other employees have an incentive or are under pressure, which provides a reason to commit fraud. Second, circumstances exist that provide an opportunity for a fraud to be perpetrated. Third, those involved are able to rationalize committing a fraudulent act.

Misstatements Arising From Fraudulent Financial Reporting

Misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve acts such as the following:

- Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared
- Misrepresentation in, or intentional omission from, the financial statement of events, transactions, or other significant information
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure

Misstatements Arising From Misappropriation of Assets

Misstatements arising from misappropriation of assets involve the theft of an entity’s assets where the effect of the theft causes the financial statement not to be presented, in all material respects, in conformity with generally accepted accounting principles. Misappropriation of assets can be accomplished in various ways, including embezzling receipts, stealing assets, or causing an entity to pay for goods or services not received. Misappropriation of assets may be accomplished by false or misleading records or documents, possibly created by circumventing controls, and may involve one or more individuals among management, employees, or third parties.

The Importance of Exercising Professional Skepticism

Because of the characteristics of fraud, the auditor’s exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence, and requires an ongoing assessment of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor’s belief about management’s honesty and integrity.

Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud

Paragraph .14 of AU section 316 states that members of the audit team should discuss the potential for material misstatement due to fraud prior to or in conjunction with his or her information gathering procedures. The discussion should include the following:

- An exchange of ideas or brainstorming among the audit team members, including the auditor with final responsibility for the audit, about how and where they believe the entity’s financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated
- An emphasis on the importance of maintaining the proper state of mind throughout the audit regarding the potential for material misstatement due to fraud
As previously noted in AAM section 3120, the brainstorming session to discuss the entity’s susceptibility to material misstatements due to fraud could be held concurrently with the brainstorming session to discuss the potential of the risks of material misstatement that is required under AU section 314.

.10 Communication among the audit team members about the risks of material misstatement due to fraud should continue throughout the audit. See paragraphs .14–.18 of AU section 316 for further guidance.

Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

.11 In obtaining an understanding of the entity and its environment, including its internal control, information may come to the auditor’s attention that should be considered in identifying risks of material misstatements due to fraud. The auditor should perform procedures to obtain information that is used to identify the risks of material misstatement due to fraud, including the following:

- Making inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed
- Considering any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit
- Considering whether one or more fraud risk factors exist
- Considering other information that may be helpful in identifying risks of material misstatement due to fraud

See paragraphs .19–.34 of AU section 316 for further guidance.

.12 Although fraud usually is concealed and management’s intent is difficult to determine, the presence of certain risk factors or other conditions may suggest the possibility that fraud may exist. However, these conditions may be the result of circumstances other than fraud.

.13 The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by fraud or error. Because fraud is usually concealed, material misstatements due to fraud are difficult to detect. Nevertheless, the auditor may identify fraud risk factors that do not necessarily indicate the existence of fraud, but often are present in circumstances where fraud exists. A fraud risk factor is an event or condition that indicates the following:

- An incentive or pressure to perpetrate fraud
- Opportunities to carry out the fraud
- Attitudes or rationalizations to justify a fraudulent action

Identifying Risks That May Result in a Material Misstatement Due to Fraud

.14 In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in the context of the three conditions present when a material misstatement due to fraud occurs—that is, incentives and pressures, opportunities, and attitudes and rationalizations. However, the auditor should not assume that all three conditions must be observed or evident before concluding that there are identified risks.

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1 Paragraph .102 of AU section 314, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (AICPA Professional Standards, vol. 1), states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. This requirement provides a link between the auditor’s consideration of fraud and the auditor’s assessment of risk and the auditor’s procedures in response to those assessed risks.
The identification of a risk of material misstatement due to fraud involves the application of professional judgment and includes the consideration of the attributes of the risk, including the following:

- The type of risk that may exist, that is, whether it involves fraudulent financial reporting or misappropriation of assets
- The significance of the risk, that is, whether it is of a magnitude that could lead to result in a possible material misstatement of the financial statements
- The likelihood of the risk, that is, the likelihood that it will result in a material misstatement in the financial statements
- The pervasiveness of the risk, that is, whether the potential risk is pervasive to the financial statements as a whole or specifically related to a particular assertion, account, or class of transactions

Material misstatements due to fraudulent financial reporting often result from an overstatement or understatement of revenues. Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition. In addition, even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur and, accordingly, the auditor should address that risk (see paragraph .57 of AU section 316) apart from any conclusions regarding the existence of more specifically identifiable risks.

Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity’s Programs and Controls That Address the Risks

As part of the understanding of internal control sufficient to plan the audit required by AU section 314, the auditor should evaluate whether entity programs and controls that address identified risks of material misstatement due to fraud have been suitably designed and placed in operation and assess those risks taking into account that evaluation.

Responding to the Results of the Assessments

The auditor’s response to the assessment of the risks of material misstatement due to fraud involves the application of professional skepticism in gathering and evaluating audit evidence and is influenced by the nature and significance of the risks identified as being present and the entity’s programs and controls that address these identified risks. The auditor’s response can be (1) an overall response on how the audit is conducted, (2) a response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed, or (3) a response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur.

The auditor may conclude that it would not be practicable to design auditing procedures that sufficiently address the risks of material misstatement due to fraud. In that case, withdrawal from the engagement with communication to the appropriate parties may be an appropriate course of action.

Overall Responses to the Risk of Material Misstatement

Judgments about the risk of material misstatement due to fraud have an overall effect on how the audit is conducted in the following ways:

Assignment of personnel and supervision. The knowledge, skill, and ability of personnel assigned significant engagement responsibility should be commensurate with the auditor’s assessment of the risk.

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2 Paragraph .03 of AU section 318, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (AICPA, Professional Standards, vol. 1), states that to reduce audit risk to an acceptably low level, the auditor should determine overall responses to address the assessed risks of material misstatement at the financial statement level and should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. See paragraphs .04 and .07 of AU section 318. This requirement provides a link between the auditor’s consideration of fraud and the auditor’s assessment of risk and the auditor’s procedures in response to those assessed risks.
risks of material misstatement due to fraud for the engagement. In addition, the extent of supervision should reflect the risks of material misstatement due to fraud.

**Accounting principles.** The auditor should consider management’s selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions.

**Predictability of auditing procedures.** The auditor should incorporate an element of unpredictability in the selection from year to year of auditing procedures to be performed.

### Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed to Address the Identified Risks

.21 The auditing procedures performed in response to identified risks of material misstatement due to fraud will vary depending on the types of risks identified and the account balances, classes of transactions, and related assertions that may be affected. These procedures may involve both substantive tests and tests of the operating effectiveness of the entity’s programs and controls. The auditor’s responses to address specifically identified risks of material misstatement due to fraud may include changing the nature, timing, and extent of auditing procedures. See paragraphs .52–.56 of AU section 316 for more guidance.

### Responses to Further Address the Risk of Management Override of Controls

.22 Management is in a unique position to perpetrate fraud because of its ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding established controls that otherwise appear to be operating effectively. Accordingly, in addition to overall responses and responses that address specifically identified risks of material misstatement due to fraud, certain procedures should be performed to further address the risk of management override of controls, as discussed in paragraphs .58–.67 of AU section 316.

### Evaluating Audit Evidence

.23 The auditor’s assessment of the risks of material misstatement due to fraud should be ongoing throughout the audit. The auditor should consider whether analytical procedures performed in planning the audit result in identifying any unusual or unexpected relationships that should be considered in assessing the risks of material misstatements due to fraud. The auditor also should evaluate whether analytical procedure that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud.

.24 At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of audit procedures and other observations affect the assessment of the risk of material misstatement due to fraud made earlier in the audit. Such an evaluation may provide further insight into the risk of material misstatement due to fraud and whether there is a need for additional or different audit procedures to be performed.

.25 When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. If the auditor has determined that misstatements are or may be the result of fraud, but the effect of the misstatements is not material, the auditor, nevertheless, should evaluate the implications, especially those dealing with the organizational position of the person(s) involved. If the matter involves higher level management, even though the amount itself is not material to the financial statements, it may be indicative of a more pervasive problem, for example, implications about the integrity of management. In such circumstances, the auditor should reevaluate the assessment of the risk of material misstatement due to fraud and its resulting impact on (a) the nature, timing, and extent of the tests
of balances or transactions and (b) the assessment of the effectiveness of controls if control risk was assessed below the maximum.

.26 If the auditor believes that the misstatement is, or may be, the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should

- attempt to obtain additional audit evidence to determine whether material fraud has occurred or is likely to have occurred and, if so, its effect on the financial statements and the auditor’s report thereon;
- discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and those charged with governance;
- consider the implications for other aspects of the audit; and
- if appropriate, suggest that the client consult with legal counsel.

.27 The auditor’s consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to those charged with governance or others with equivalent authority and responsibility. Whether the auditor concludes that withdrawal from the engagement is appropriate may depend on (a) the implications about the integrity of management and (b) the diligence and cooperation of management or the board of directors in investigating the circumstances and taking appropriate action. Because of the variety of circumstances that may arise, it is not always possible to definitely describe when withdrawal is appropriate. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

Communicating About Possible Fraud to Management, Those Charged With Governance, and Others

.28 Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to those charged with governance. In addition, the auditor should reach an understanding with those charged with governance regarding the nature and extent of communications with the committee about misappropriations perpetrated by lower level employees.

.29 If the auditor, as a result of the assessment of the risks of material misstatement, has identified risks of material misstatement due to fraud that have continuing control implications (whether or not transactions or adjustments that could be the result of fraud have been detected) the auditor should consider whether these risks represent significant deficiencies or material weaknesses in the entity’s internal control that should be communicated to management and those charged with governance. Also the auditor should consider whether the absence of or deficiencies in programs and controls to mitigate specific risks of fraud or to otherwise help prevent, deter, and detect fraud represent significant deficiencies or material weaknesses that should be communicated to management and those charged with governance.

.30 The auditor should recognize that in the following circumstances a duty to disclose outside the entity may exist

- to comply with certain legal and regulatory requirements.
- to a successor auditor when the successor makes inquiries in accordance with AU section 315, Communications Between Predecessor and Successor Auditors (AICPA, Professional Standards, vol. 1).
- in response to a subpoena.
to a funding agency or other specified agency in accordance with requirements for the audits of entities that receive governmental financial assistance.

Because potential conflicts with the auditor’s ethical and legal obligations for confidentiality of client matters may be complex, the auditor may wish to consult with legal counsel before discussing matters of fraud or possible fraud with parties outside the client.

**Documenting the Auditor’s Consideration of Fraud**

.31 The auditor should document the following:

- The discussion among engagement personnel in planning the audit regarding the susceptibility of the entity’s financial statements to material misstatement due to fraud, including how and when the discussion occurred, the audit team members who participated, and the subject matter discussed
- The procedures performed to obtain information necessary to identify and assess the risks of material misstatement due to fraud
- Specific risks of material misstatement due to fraud that were identified and a description of the auditor’s response to those risks
- If the auditor has not identified, in a particular circumstance, improper revenue recognition as a risk of material misstatement due to fraud, the reasons supporting the auditor’s conclusion
- The results of the procedures performed to further address the risk of management override of controls
- Other conditions and analytical relationships that caused the auditor to believe that additional auditing procedures or other responses were required and any further responses the auditor concluded were appropriate, to address such risks or other conditions

The nature of the communications about fraud made to management, those charged with governance, and others.

**Fraud Risk Factor Memory Jogger**

.32 An auditor may find this memory jogger helpful during planning and at other stages of the audit, when considering fraud risk factors and assessing the risk of material misstatement due to fraud. The following listing contains example risk factors for small, privately owned businesses. If used, this memory jogger should be tailored for the particular client being audited. Identified or possible risk factors should be added to the list. An auditor may also decide to remove the example factors from the list based on the circumstances. In any event, be sure to consider fraud risk factors that relate to fraudulent financial reporting and misappropriation of assets in every related category presented. An auditor should feel free to use this practice aid as he or she sees fit (for example, adding attachments, redesigning the form of the memory jogger). Finally, note that AU section 316 does not require an auditor to use a memory jogger or checklist of fraud risk factors.
### Part 1—Fraudulent Financial Reporting

<table>
<thead>
<tr>
<th>Fraud risk factors considered</th>
<th>Present at client?</th>
<th>Audit response developed?</th>
<th>Audit response documented? (W/P Ref.)</th>
<th>Additional information</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Incentives and Pressures</strong></td>
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<tr>
<td>a. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by) the following:</td>
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<td>(1) High degree of competition or market saturation, accompanied by declining margins</td>
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<td>(2) New accounting, statutory, or regulatory requirements</td>
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<td>(3) Significant declines in customer demand and increasing business failures in either the industry or the economy in which the entity operates</td>
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<td>(4) High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates</td>
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<td>(5) Operating losses making the threat of bankruptcy or foreclosure, imminent</td>
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<td>(6) Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth</td>
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<td>(7) Rapid growth or unusual profitability especially compared to that of other companies in the same industry</td>
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<td>b. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:</td>
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<td>(1) Need to obtain additional debt or equity financing to stay competitive, including financing of major research and development or capital expenditures</td>
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<td>(2) Marginal ability to meet debt repayment or other debt covenant requirements</td>
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<td>c. Management’s personal net wealth is threatened by the entity’s financial performance arising from the following:</td>
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<td>(1) Heavy concentrations of their personal net worth in the entity.</td>
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<td>(2) Personal guarantees of debt of the entity that are significant to their personal net worth.</td>
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<tr>
<td>Fraud risk factors considered</td>
<td>Present at client?</td>
<td>Audit response developed? (W/P Ref.)</td>
<td>Additional information</td>
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<td>(3) Adverse consequences on significant matters if good financial results are reported. Specific examples include management’s motivation to inappropriately reduce income taxes, to defraud a divorced spouse or a partner of his or her share of the profits or assets of a business, or to convince a judge or arbitrator that the business in dispute is not capable of providing adequate cash flow. Keep in mind that you are not required to plan your audit to discover personal information (for example, marital status) of the owner-manager. However, if you become aware of such information, you may consider it in your assessment of risk of material misstatement due to fraud.</td>
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| d. | There is excessive pressure on management or operating personnel to meet financial targets set by the owner, including sales or profitability incentive goals. |

### B. Opportunities

**a.** The nature of the industry or the entity’s operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

1. Significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm

2. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate

3. Significant, unusual, or highly complex transactions, especially those close to year-end that pose difficult “substance over form” questions

**b.** There is a complex or unstable organizational structure as evidenced by the following:

1. Difficulty in determining the organization or individuals that have controlling interest in the entity

2. Overly complex organizational structure involving unusual legal entities or managerial lines of authority

3. High turnover of senior management or counsel

**c.** Internal control components are deficient as a result of the following:

1. Inadequate monitoring of controls, including automated controls

2. High turnover rates or employment of ineffective accounting staff.

3. Ineffective accounting and information systems including situations involving reportable conditions

### C. Attitudes and Rationalizations

(continued)
<table>
<thead>
<tr>
<th>Fraud risk factors considered</th>
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<th>Audit response documented? (WP Ref.)</th>
<th>Additional information</th>
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<tbody>
<tr>
<td>1. A failure for management to display and communicate an appropriate attitude regarding internal control and the financial reporting process</td>
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<td>2. Ineffective communication and support of the entity’s values or ethical standards by management or the communication of inappropriate values or ethical standards</td>
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<td>3. Nonfinancial management’s excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates</td>
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<td>4. Known history of violations or claims against the entity, its owner or senior management alleging fraud or violations of laws and regulations</td>
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<td>5. A practice by management of committing to creditors and other third parties to achieve aggressive or unrealistic forecasts</td>
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<td>6. Management failing to correct known reportable conditions on a timely basis</td>
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<td>7. An interest by management in employing inappropriate means to minimize reported earnings for tax motivated reasons</td>
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<td>8. Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality</td>
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<td>9. The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:</td>
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<td>a. Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters</td>
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<td>b. Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor’s report</td>
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<td>c. Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or those charged with governance</td>
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<td>d. Dominering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor’s work or the selection or continuance of audit personnel assigned to the engagement</td>
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</table>
### Part 2—Misappropriation of Assets

<table>
<thead>
<tr>
<th>Fraud risk factors considered</th>
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<th>Additional information</th>
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<tbody>
<tr>
<td><strong>A. Incentives and Pressures</strong></td>
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<tr>
<td>a.</td>
<td>Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.</td>
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<td>b.</td>
<td>Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:</td>
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<td>(1)</td>
<td>Known or anticipated future layoffs</td>
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<td>(2)</td>
<td>Promotions, compensation, or other rewards inconsistent with expectations</td>
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<td><strong>B. Opportunities</strong></td>
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<td>a.</td>
<td>Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:</td>
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<tr>
<td>(1)</td>
<td>Large amounts of cash on hand or processed</td>
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<td>(2)</td>
<td>Company issued credit cards</td>
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<td>(3)</td>
<td>Inventory items that are small in size, of high value, or in high demand</td>
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<td>(4)</td>
<td>Easily convertible assets</td>
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<td>(5)</td>
<td>Fixed assets, that, are small in size, marketable, or lacking observable identification of ownership</td>
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<td>b.</td>
<td>Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:</td>
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<tr>
<td>(1)</td>
<td>Inadequate segregation of duties or independent checks. Inadequate segregation of duties is quite often understandable in a small business environment in that it’s a function of the entity’s size. However, you may consider it in conjunction with other risk factors and with mitigating controls.</td>
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<td>(2)</td>
<td>Inadequate management oversight of employees responsible for assets</td>
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<td>(3)</td>
<td>Inadequate job applicant screening of employees with access to assets</td>
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(continued)
### Fraud risk factors considered

<table>
<thead>
<tr>
<th></th>
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<tr>
<td>(4)</td>
<td>Inadequate record keeping with respect to assets.</td>
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<td>(5)</td>
<td>Inadequate system of authorization and approval of transactions (for example, in purchasing).</td>
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<td>(6)</td>
<td>Inadequate physical safeguards over cash, investments, inventory, or fixed assets.</td>
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<td>(7)</td>
<td>Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.</td>
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<td>(8)</td>
<td>Lack of mandatory vacations for employees performing key control functions.</td>
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<td>(9)</td>
<td>Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.</td>
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<tr>
<td>(10)</td>
<td>Inadequate access controls over automated records.</td>
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</tbody>
</table>

### C. Attitudes and Rationalizations

1. Disregard for the need for monitoring or reducing risks related to misappropriations of assets
2. Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies
3. Behavior indicating displeasure or dissatisfaction with the company or its treatment of the employee
4. Changes in behavior or lifestyle that may indicate assets have been misappropriated

[The next page is 3311.]
AAM Section 3150

Illegal Acts

General Comments

.01 The term illegal acts refers to violations of laws or governmental regulations. Illegal acts by clients do not include personal misconduct by the entity’s personnel unrelated to their business activities.

.02 Whether an act is illegal is a determination that is normally beyond the auditor’s professional competence. The auditor’s training and experience may provide a basis for recognition that some client acts coming to his or her attention may be illegal.

Direct and Material Effect Illegal Acts

.03 The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. For example, tax laws affect accruals and the amount recognized as expense in the accounting period; applicable laws and regulations may affect the amount of revenue accrued under government contracts.

.04 The auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality per se.

.05 The auditor’s responsibility to detect and report misstatement resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for errors or fraud as described in AU section 110, Responsibilities and Functions of the Independent Auditor (AICPA, Professional Standards, vol. 1). That is, the auditor should design the audit to provide reasonable assurance that financial statement amounts are free from material misstatement resulting from these direct-effect illegal acts.

Other Illegal Acts

.06 Entities may be affected by many other laws or regulations, including those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, and price fixing or other antitrust violations. Generally, these laws and regulations relate more to an entity’s operating aspects than to its financial and accounting aspects and their financial statement effect is indirect.

.07 An auditor ordinarily does not have sufficient basis for recognizing possible violations of such laws and regulations. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality. Normally, an audit conducted in accordance with generally accepted auditing standards does not include audit procedures specifically designed to detect illegal acts having an indirect effect on financial statements.

Engagement Planning Procedures

.08 The auditor should assess the risks that the entity has not complied with laws and regulations that have a direct and material effect on the determination of financial statement amounts (except disclosure of contingencies) in the planning phase of the audit.
Matters that may influence the auditor’s assessment include the following:

a. Management’s understanding of the requirements of laws and regulations pertinent to audit objectives
b. The nature and extent of noncompliance noted in prior audits
c. Changes in requirements since the last audit
d. Internal control components designed to give management reasonable assurance that the entity complies with those laws and regulations
e. The client’s policy relative to the prevention of illegal acts

Normally, there is no need to include audit procedures specifically designed to detect illegal acts. However, if the auditor becomes aware of information that raises suspicions, he or she is obligated to apply additional procedures to determine whether an illegal act has, in fact, occurred (see paragraphs .07–.11 of AU section 317, Illegal Acts by Clients [AICPA, Professional Standards, vol. 1]).

[The next page is 3331.]
AAM Section 3155

Analytical Procedures

General Comments

.01 Analytical procedures are a natural extension of the auditor’s understanding of the client’s business and add to his or her understanding because the key factors that influence the client’s business may be expected to affect the client’s financial information. Analytical procedures are used in all three stages of the audit. In the planning stage, the purpose of analytical procedures is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain audit evidence for specific account balances or classes of transactions. In the substantive testing stage of the audit, the purpose of analytical procedures is to obtain evidence, sometimes in combination with other substantive procedures, to identify misstatements in account balances and, thus, to reduce the risk that misstatements will remain undetected. The auditor’s reliance on substantive tests to achieve an audit objective related to a particular assertion may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedure or procedures to use to achieve a particular audit objective is based on the auditor’s judgment about the expected effectiveness and efficiency of the available procedures. In the overall review stage, the objective of analytical procedures is to assist the auditor in assessing the conclusions reached and in evaluating the overall financial statement presentation. In all cases, the effectiveness of analytical procedures lies in developing expectations that can reasonably be expected to identify unexpected relationships.

.02 Understanding financial relationships is essential in planning and evaluating the results of analytical procedures and generally requires knowledge of the client and the industry or industries in which the client operates. An understanding of the purposes of analytical procedures and the limitations of those procedures is also important. Accordingly, the identification of the relationships and types of data used, as well as conclusions reached when recorded amounts are compared to expectations, requires judgment by the auditor. Analytical procedures should be applied, to some extent, for the purposes referred to in the planning stage and the overall review stage above for all audits of financial statements made in accordance with generally accepted auditing standards. In addition, in some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives.

Analytical Procedures

.03 Analytical procedures are defined in paragraph .02 of AU section 329, Analytical Procedures (AICPA, Professional Standards, vol. 1), as “evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. ... A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of conditions to the contrary.” The definition implies several key concepts:

- The “evaluations of financial information” suggests that analytical procedures will be used to understand or test financial statement relationships or balances.
- The “study of plausible relationships” implies an understanding of what can reasonably be expected and involves a comparison of the recorded book values with an auditor’s expectations.
- “Relationships among both financial and nonfinancial data” suggests that both types of data can be useful in understanding the relationships of the financial information and, therefore, in forming an expectation.

1 In accordance with paragraph .06 of AU section 314, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (AICPA, Professional Standards, vol. 1), analytical procedures are also performed as risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control. Refer to AU section 314 for further guidance.
.04 Also, in accordance with paragraph .09 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), the auditor should apply analytical procedures in planning the audit to assist in understanding the entity and its environment and to identify areas that may represent specific risks relevant to the audit. For example, analytical procedures may be helpful in identifying the existence of unusual transactions or events and amounts, ratios, and trends that might indicate matters that have financial statement and audit implications. In performing analytical procedures as risk assessment procedures, the auditor should develop expectations about plausible relationships that are reasonably expected to exist. When comparison of those expectations with recorded amounts or ratios developed from recorded amounts yields unusual or unexpected relationships, the auditor should consider those results in identifying risks of material misstatement. However, when such analytical procedures use data aggregated at a high level (which is often the situation), the results of those analytical procedures provide only a broad initial indication about whether a material misstatement may exist. Accordingly, the auditor should consider the results of such analytical procedures along with other information gathered in identifying the risks of material misstatement.

.05 Analytical procedures performed during the overall review stage are designed to assist the auditor in assessing that (a) all significant fluctuations and other unusual items have been adequately explained and (b) the overall financial statement presentation makes sense based on the audit results and the auditor’s knowledge of the business.

.06 During the substantive testing stage, analytical procedures may be used to obtain assurance that material misstatements are not likely to exist in financial statement account balances. If analytical procedures are used for substantive testing, the auditor should focus his or her analytical procedures on particular assertions about account balances and should give detailed attention to the underlying factors that affect those account balances through the development of an expectation independent of the recorded balance. Therefore, substantive analytical procedures generally are performed with more rigor and precision than those used for planning or overall review.

.07 AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on the use of analytical procedures as substantive procedures. In designing substantive analytical procedures, the auditor should consider such matters as the following:

- The suitability of using substantive analytical procedures, given the assertions
- The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed
- Whether the expectation is sufficiently precise to identify the possibility of a material misstatement at the desired level of assurance
- The amount of any difference in recorded amounts from expected values that is acceptable

The auditor should consider testing the controls, if any, over the entity’s preparation of information to be used by the auditor in applying analytical procedures. When such controls are effective, the auditor has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. When designing substantive analytical procedures, the auditor should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting some types of fraud. Alternatively, the auditor may consider whether the information was subjected to audit testing in the current or prior period. In determining the audit procedures to apply to the information upon which the expectation for substantive analytical procedures is based, the auditor should consider the guidance in paragraph .14 of AU section 318.

.08 In planning substantive analytical procedures, the auditor should consider the amount of difference from the expectation that can be accepted without further investigation. This consideration is influenced
primarily by tolerable misstatement and should be consistent with the desired level of assurance. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account balance, class of transactions, or disclosure could aggregate to an unacceptable amount. In designing substantive analytical procedures, the auditor should increase the desired level of assurance as the risk of material misstatement increases.

Analytical Procedure Process: Four Phases

.09 The use of analytical procedures can be considered a process that consists of four phases. The first phase is the expectation-formation process. In this phase, the auditor forms an expectation of an account balance or financial relationship. In doing so, the auditor determines the precision of the expectation and, thus, in part, the effectiveness of the analytical procedure.

.10 The remaining three phases consist of the identification, investigation, and evaluation of the difference between the auditor’s expected value and the recorded book value in light of the auditor’s materiality assessment. In the second phase, identification, the auditor identifies whether an unusual fluctuation exists between the expected and recorded amounts. In the third, investigation, the auditor investigates the cause of unexpected differences by considering possible causes and searching for information to identify the most probable causes. Finally, in the evaluation phase, the auditor evaluates the likelihood of material misstatement and determines the nature and extent of any additional auditing procedures that may be required.

Expectation Formation (Phase I)

.11 Forming an expectation is the most important phase of the analytical procedure process. The more precise the expectation (that is, the closer the auditor’s expectation is to the correct balance or relationship), the more effective the procedure will be at identifying potential misstatements. Also, AU section 329 states that the expectation should be precise enough to provide the desired level of assurance that differences that may be potential misstatements, individually or when aggregated with other misstatements, would be identified for the auditor to investigate.

.12 The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor’s understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:

- a. Financial information for comparable prior period(s) giving consideration to known changes
- b. Anticipated results, for example, budgets or forecasts including extrapolations from interim or annual data
- c. Relationships among elements of financial information within the period
- d. Information regarding the industry in which the client operates, for example, gross margin information
- e. Relationships of financial information with relevant nonfinancial information

.13 The effectiveness of an analytical procedure is a function of three factors related to the precision with which the expectation is developed: (a) the nature of the account or assertion, (b) the reliability and other characteristics of the data, and (c) the inherent precision of the expectation method used.

Identification and Investigation (Phases II and III)

.14 The next two phases of the analytical procedure process consist of identification and investigation. Identification begins by comparing the auditor’s expected value with the recorded amount. Given that the auditor developed an expectation with a particular amount of difference that could be accepted without further explanation, he or she then compares the unexpected differences with the threshold. In substantive testing, an auditor testing for the possible misstatement of the book value of an account determines whether
the audit difference was less than the auditor’s threshold. If the difference is less than the acceptable threshold, taking into consideration the desired level of assurance from the procedure, the auditor accepts the book value without further investigation. If the difference is greater, the next step is to investigate the difference.

.15 In investigation, the auditor should evaluate possible explanations for the difference. The greater the precision of the expectation (that is, the closer the expectation is to the correct amount) the greater the likelihood that the difference between the expected and recorded amounts is due to misstatement rather than nonmisstatement causes. The difference between an auditor’s expectation and the recorded book value of an account (value of an account not subject to auditing procedures) can be due to any or all of the following three causes: (a) the difference is due to misstatements, (b) the difference is due to inherent factors that affect the account being audited (for example, the predictability of the account or account subjectivity), and (c) the difference is due to factors related to the reliability of data used to develop the expectation (for example, data that have been subject to auditing procedures versus data that have not been subject to auditing procedures). The greater the precision of the expectation, the more likely the difference between the auditor’s expectation and the recorded value will be due to misstatements (cause [a]). Conversely, the less precise the expectation, the more likely the difference is due to factors related to the precision of the expectation (causes [b] and [c]).

Evaluation (Phase IV)

.16 The final phase of the analytical procedure process consists of evaluating the difference between the auditor’s expected value and the recorded amount. It is usually not practicable to identify factors that explain the exact amount of a difference identified for investigation. However, the auditor should attempt to quantify that portion of the difference for which plausible explanations can be obtained and, where appropriate, corroborated and determine that the amount that cannot be explained is sufficiently small to enable him or her to conclude on the absence of material misstatement.

.17 If a reasonable explanation can not be obtained, in accordance with paragraph .50 of AU section 312, Audit Risk and Materiality in Conducting an Audit (AICPA, Professional Standards, vol. 1), the auditor must consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity. In making this evaluation, in relation to particular classes of transactions, account balances, and disclosures, the auditor should consider the size and nature of the misstatements and the particular circumstances of their occurrence and determine the effect of such misstatements on the financial statements taken as a whole. Misstatements should be aggregated in a way that enables the auditor to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole.” In this case, the auditor should aggregate the misstatement, depending on materiality considerations, with other misstatements the entity has not corrected in the manner discussed in AU section 312.

Engagement Planning Procedures

.18 As stated previously, the purpose of applying analytical procedures in planning the audit is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain audit evidence for specific account balances or classes of transactions. To accomplish this, the analytical procedures used in planning the audit should focus on (a) enhancing the auditor’s understanding of the clients’ business and the transactions and events that have occurred since the last audit date, and (b) identifying areas that may represent specific risks relevant to the audit. Thus, the objective of the procedures is to identify such things as the existence of unusual transactions and events and amounts, ratios, and trends that might indicate matters that have financial statement and audit planning ramifications.

.19 Analytical procedures used in planning the audit generally use data aggregated at a high level. Furthermore, the sophistication, extent, and timing of the procedures, which are based on the auditor’s judgment, may vary widely depending on the size and complexity of the client. For some entities, the procedures may consist of reviewing changes in account balances from the prior to the current year using the general ledger or the auditor’s preliminary or unadjusted working trial balance. In contrast, for other entities, the procedures might involve an extensive analysis of quarterly financial statements. In both cases, the
analytical procedures, combined with the auditor’s knowledge of the business, serve as a basis for additional inquiries and effective planning.

20 Although analytical procedures used in planning the audit often use only financial data, sometimes relevant, nonfinancial information is considered as well. For example, number of employees, square footage of selling space, volume of goods produced, and similar information may contribute to accomplishing the purpose of the procedures.

Audit Documentation Requirements

21 Paragraph .22 of AU section 329 states that when an analytical procedure is used as the principal substantive test of a significant financial statement assertion the auditor should document all of the following:

- The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development
- Results of the comparison of the expectation to the recorded amounts or ratios developed from the recorded amounts
- Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures

Analytical Procedures Audit Guide

22 For additional guidance, practitioners may refer to the AICPA Audit Guide Analytical Procedures. The guide provides practical guidance for auditors on the effective use of analytical procedures. Specifically, the audit guide includes a discussion of AU section 329; concepts and definitions; a series of questions and answers, grouped in the following five categories: precision of the expectation, relationship of analytical procedures to the audit risk model, evaluation and investigation, purpose of analytical procedures, and fraud; and a case study illustrating the four types of expectation methods discussed in chapter 1 of the guide: trend analysis, ratio analysis, reasonableness testing, and regression analysis.

23 The audit guide also includes illustrations that demonstrate the importance of forming expectations and considering the precision of the expectation, two of the most misunderstood concepts from AU section 329. The concepts discussed are applicable for all three stages of the audit (planning, substantive testing, and review). However, the audit guide focuses principally on how the concepts are applied to substantive testing because in designing substantive procedures, auditors ordinarily desire a specified level of audit assurance. To obtain the audit guide, call the AICPA order department at (888) 777-7077 and ask for product no. 012558.

[The next page is 3361.]
**AAM Section 3160**

**Audit Assignment Controls**

.01

**Audit Time Budget — Sample A**

Client ____________________________________________________ Audit date ____________________________________________

Prepared by_______________________________________________

Approved:

Supervisor ________________________ Date _________________

Partner __________________________ Date ________________

Preliminary work: Final work:

Start ______________________ End _________________________ Start ______________________ End_______________________

<table>
<thead>
<tr>
<th>Budget (in hours)</th>
<th>May to Nov.</th>
<th>Dec. to April</th>
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<tbody>
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<td>Cash</td>
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<td>Receivables:</td>
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<tr>
<td>Confirmation of balances</td>
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<td></td>
</tr>
<tr>
<td>Review ledgers, etc.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Observation of physical counts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Price tests, etc.</td>
<td></td>
<td></td>
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<tr>
<td>Securities and investments</td>
<td></td>
<td></td>
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<tr>
<td>Property, plant, and equipment</td>
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<td></td>
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<tr>
<td>Accumulated depreciation and amortization</td>
<td></td>
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<tr>
<td>Other assets</td>
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<tr>
<td>Notes and accounts payable</td>
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<td></td>
</tr>
<tr>
<td>Tax accruals</td>
<td></td>
<td></td>
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<tr>
<td>Other liabilities</td>
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<tr>
<td>Capital stock</td>
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<tr>
<td>Retained earnings</td>
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<tr>
<td>Other equity accounts</td>
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<tr>
<td>Income accounts</td>
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<tr>
<td>Costs and expense accounts</td>
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<td></td>
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<td></td>
</tr>
<tr>
<td>Current provision for taxes</td>
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<tr>
<td>Other income and expense accounts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minutes, agreements, etc.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Conferences with client</td>
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<td></td>
</tr>
<tr>
<td>General supervision and planning</td>
<td></td>
<td></td>
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<tr>
<td>Review computer programs and auditability</td>
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<td></td>
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<tr>
<td>Review of internal control</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Review and update permanent files</td>
<td></td>
<td></td>
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<tr>
<td>Travel</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Report and statement review</td>
<td></td>
<td></td>
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<tr>
<td>Other matters</td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total budgeted hours</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*(Excludes tax and report departments’ time)*
AAM §3160.02

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Actual

Budget

Date
Accountant’s
initials
color-coded

Total hours

.02

Total
Supervisor
or manager
Senior
Assistant
Audit program
Prior period reports
Working papers, etc.
Trial balance and
adjusting entries
Permanent file

General

Financial statement
companion
Transactions since
balance-sheet date
Preparation of
reports
Internal control
quest. and mgmt. letter
Time summary
Supervision

Cash
Inventories

Audit Time Budget — Sample B

Correspondence and
conferences
Review in-house
computer programs
Audit of /with
computer
General ledger and
journal entries
In banks and on hand
Receipts and
disbursements
Notes/accts. rec. and
allowance for losses
Observation
Comparison of
quantities
Valuation
Clerical accuracy and
analytical review
Prepaid expenses
Other current assets
Fixed assets and
depreciation
Investments
Other assets
Notes payable and
long-term debt
Accounts payable
Other current
liabilities
Other long-term liabilities
and deferred income
Stockholders equity
Contingent liabilities
Sales and revenue
Payrolls
Other expense and income
tests and analyses
Preparation of tax
returns

Other
(describe)

Engagement Planning and Administration

3362

76

11-07


## Audit Time Analysis (Short Form)

<table>
<thead>
<tr>
<th>Prior Years</th>
<th>Budgeted Hours</th>
<th>Actual Daily Hours</th>
<th>Next Year's Budget</th>
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<tbody>
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<td>Week Beginning</td>
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<tr>
<td>Administration</td>
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<tr>
<td>Accounting systems review</td>
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<tr>
<td>Confirmations</td>
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<tr>
<td>Permanent file</td>
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<tr>
<td>Client advisory comments</td>
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<td></td>
</tr>
<tr>
<td>Report preparation</td>
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<td></td>
<td></td>
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<tr>
<td>Tax returns</td>
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<td></td>
<td></td>
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<tr>
<td>Initial review</td>
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<tr>
<td>Overall review</td>
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<tr>
<td>Detailed review</td>
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<tr>
<td>Tax accrual review</td>
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<tr>
<td>Trial balance</td>
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<tr>
<td>Cash</td>
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<tr>
<td>Receivables</td>
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<td>Inventories</td>
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<td>Other assets</td>
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<tr>
<td>Liabilities</td>
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<tr>
<td>Equity</td>
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<tr>
<td>Operating accounts</td>
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<td>Totals</td>
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<tr>
<td>Totals</td>
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<td>Prior Years Budgeted Hours</td>
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<td>Client conferences</td>
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<tr>
<td>Planning and scheduling</td>
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<td>Staff supervision</td>
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<td>Accounting systems review</td>
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<td>Permanent file</td>
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<tr>
<td>Client advisory comments</td>
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<tr>
<td>Report preparation</td>
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<td>Financial statements</td>
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<td>Detailed review</td>
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<td>Tax accrual review</td>
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## Audit Time Analysis (Long Form)—continued

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<th>Actual Daily Hours</th>
<th>Next Year's Budget</th>
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<td>Total</td>
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<td>Year end verification</td>
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<td>Cash</td>
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<td>Notes receivable</td>
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<td>Accounts receivable</td>
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<td>Inventories</td>
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<td></td>
<td></td>
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<td>Prepaid expenses</td>
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<td>Intercompany accounts</td>
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<td>Securities and investments</td>
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<td>Fixed assets</td>
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<td>Other assets</td>
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<td></td>
<td>Notes payable</td>
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<td>Accounts payable</td>
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<td></td>
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<td></td>
<td>Tax grouping and accrual</td>
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<td>Accrued liabilities</td>
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<td>Deferred credits</td>
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<td>Contingencies and commitments</td>
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<td>Equity</td>
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<td>Operating accounts</td>
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<td>Subtotal from previous page</td>
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<td></td>
<td></td>
<td>Totals</td>
<td></td>
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<td>Accountants</td>
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<td></td>
<td>Manager</td>
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<tr>
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<td></td>
<td>In-charge</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Totals</td>
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</tr>
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</table>

AICPA Audit and Accounting Manual
AAM §3160.04
### Weekly Progress Report

<table>
<thead>
<tr>
<th>Date ____________________</th>
<th>In-charge auditor ____________________</th>
</tr>
</thead>
<tbody>
<tr>
<td>Client ____________________</td>
<td>Case ____________________</td>
</tr>
<tr>
<td>__________________________</td>
<td>__________________________</td>
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</table>

#### Staff days—seven hours

<table>
<thead>
<tr>
<th>In-charge auditor</th>
<th>Staff</th>
<th>Grand total</th>
</tr>
</thead>
<tbody>
<tr>
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</table>

#### Assistants (list):

<table>
<thead>
<tr>
<th>Assistant</th>
<th>Original Estimate</th>
<th>Used to date</th>
<th>Unused</th>
<th>Est. to complete</th>
<th>Variance</th>
</tr>
</thead>
</table>

---

[The next page is 3401.]
AAM Section 3165

Sample Engagement Letters

.01 Following are illustrative engagement letters. These illustrative letters are examples and may not include all representations necessary for a particular engagement. They may be used as a starting point in the design of specific letters and then tailored to satisfy the terms of a particular engagement. These illustrative engagement letters are intended to be used in connection with engagements of nonpublic entities and are not intended to be used in connection with audits of public entities that are required to be audited under standards set by the Public Company Accounting Oversight Board.

.02 Audit Engagement Leading to Opinion

LACKO, LYNCH, BROWN & COMPANY
Certified Public Accountants

[Date]
Mr. Matt Decker, President
Civil War Antiques, Inc.
111 Burnside Highway
Sharpsburg, Maryland 00000

Dear Mr. Decker:

This will confirm our understanding of the services we will provide to Civil War Antiques, Inc. (the Company) for the year ending December 31, 20XX.

We will audit the balance sheet of Civil War Antiques, Inc. as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, for the purpose of expressing an opinion on them.

Audit Objective

The objective of our audit is the expression of an opinion as to whether your financial statements are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America. Our audit will be conducted in accordance with auditing standards generally accepted in the United States of America and will include tests of accounting records and other procedures we consider necessary to enable us to express such an opinion. If circumstances preclude us from issuing an unqualified opinion, we will discuss the reasons with you in advance. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or decline to issue a report as a result of the engagement.

Audit Procedures

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Accordingly, the areas and number of transactions selected for testing will involve judgment. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

We will plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by errors or fraud. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. We will inform you of all matters of fraud that come
to our attention. We will also inform you of illegal acts that come to our attention, unless they are clearly inconsequential.¹

Our procedures will include tests of transactions recorded in the accounts, tests of the physical existence of inventory, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and financial institutions. At the conclusion of our audit, we will request certain written representations (a “representation letter”) from you about the financial statements and related matters.

Because an audit is designed to provide reasonable, but not absolute, assurance and because we will not perform a detailed examination of all transactions, there is a risk that material misstatements or noncompliance may exist and not be detected by us. In addition, an audit is not designed to detect immaterial misstatements, or violations of laws or governmental regulations that do not have a direct and material effect on the financial statements. However, we will inform you and those charged with governance, defined as the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including oversight of the financial reporting process, of any material errors and any fraudulent financial reporting or misappropriation of assets that comes to our attention. We will also inform you and those charged with governance of any violations of laws or governmental regulations that come to our attention, unless clearly inconsequential. Our responsibility as auditors is limited to the period covered by our audit and does not extend to matters that might arise during any later periods for which we are not engaged as auditors.

An audit includes obtaining an understanding of the entity and its environment, including its internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures. An audit is not designed to provide assurance on internal control or to identify deficiencies in internal control. However, we are responsible for communicating to you and those charged with governance internal control related matters that are required to be communicated under Statements on Auditing Standards.

Management Responsibilities

The Company’s management is responsible for the basic financial statements and all accompanying information as well as all assertions contained therein. Encompassed in that responsibility are the establishment and maintenance of effective internal control over financial reporting; the establishment and maintenance of proper accounting records; the selection of appropriate accounting principles; the safeguarding of assets; fair presentation of the financial statements with generally accepted accounting principles; and compliance with relevant laws and regulations. Management is also responsible for making all financial records and related information available to us and for the accuracy and completeness of that information.

The Company’s management is responsible for adjusting the financial statements to correct material misstatements and for affirming to us in the representation letter that the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

The Company’s management is responsible for the design and implementation of programs and controls to prevent and detect fraud and for informing us about all known or suspected fraud or illegal acts affecting the Company involving management, employees who have significant roles in internal control, and others where the fraud or illegal acts could have a material effect on the financial statements. Management’s responsibilities include informing us of your knowledge of any allegations of fraud or suspected fraud or illegal acts affecting the Company received in communications from employees, former employees, regulators, or others. In

¹ Some practitioners prefer to include in an engagement letter a clause that would indemnify them against knowing misrepresentations in jurisdictions where such clauses are permitted. Ethics Ruling No. 94, “Indemnification Clause in Engagement Letters,” under AICPA Rule 101, Independence (AICPA, Professional Standards, vol. 2, ET sec. 191 par. 188–189) states that the following indemnification clause in an engagement letter would not impair a CPA’s independence: “The client agrees to release, indemnify, and holds me (us) (and my (our) partners and our heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management.” Auditors of publicly held companies also should consider the applicable Securities and Exchange Commission rules on independence before including an indemnification clause in an engagement letter. Note that the AICPA Professional Ethics Executive Committee is currently addressing the issue of indemnification clauses. Changes to independence rules regarding auditor indemnification and related issues are still pending. Practitioners should be alert to any final guidance.
addition, the Company’s management is responsible for identifying and ensuring that the Corporation complies with applicable laws and regulations and for taking timely and appropriate steps to remedy any fraud, illegal acts, or violations of contracts or grant agreements, or abuse that we may report.

Management is responsible for making all management decisions and performing all management functions, for designating an individual with suitable skill knowledge, or experience to oversee the tax services or any other nonattest services we provide, and for evaluating the adequacy and results of those services and accepting responsibility for them.

Other Engagement Matters and Limitations

As part of our engagement for the year ending December 31, 20XX, we will review the federal and state income tax returns for Civil War Antiques, Inc. Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Professional standards require us to be independent with respect to the Company in the performance of our services. Any discussions that you have with personnel of our firm regarding employment could pose a threat to our independence. Therefore, we request that you inform us prior to any such discussions so that we can implement appropriate safeguards to maintain our independence. In addition, if you hire one of our personnel, you agree to pay us a fee of [XX] percent of that individual’s base compensation at the Company, [xx] days from the first day of employment.

Audit Administration, Fees, and Other

We may from time to time, and depending on the circumstances, use third party service providers in serving your account. We may share confidential information about you with these service providers, but remain committed to maintaining the confidentiality and security of your information. Accordingly, we maintain internal policies, procedures, and safeguards to protect the confidentiality of your personal information. In addition, we will secure confidentiality agreements with all service providers to maintain the confidentiality of your information and we will take reasonable precautions to determine that they have appropriate procedures in place to prevent the unauthorized release of your confidential information to others. In the event that we are unable to secure an appropriate confidentiality agreement, you will be asked to provide your consent prior to the sharing of your confidential information with the third party service provider. Furthermore, we will remain responsible for the work provided by any such third party service providers.2

Auditing standards generally accepted in the United States of America require that we communicate certain additional matters related to the conduct of our audit to those charged with governance. Such matters include (1) our responsibilities under auditing standards generally accepted in the United States of America; (2) an overview of the planned scope and timing of the audit; (3) significant findings from the audit, including, among others: (a) the initial selection of and changes in significant accounting policies and their application; (b) the process used by management in formulating particularly sensitive accounting estimates and the basis for our conclusions regarding the reasonableness of those estimates; (c) significant difficulties that we encountered in dealing with management related to the performance of the audit; (d) audit adjustments that could, in our judgment, either individually or in the aggregate, have a significant effect on your financial reporting process and uncorrected misstatements of the financial statements that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole; (e) any disagreements with management, whether or not satisfactorily resolved, about matters that individually or in the aggregate could be significant to the financial statements or our report; (f) management representations; (g) our views about matters that were the subject of management’s consultation with other accountants about auditing and accounting matters; (h) major issues that were discussed with management in connection with the retention of our services, including, among other matters, any discussions regarding the application of accounting principles and auditing standards, and if applicable, events or conditions

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2 Ethics Ruling No. 112, “Use of a Third-Party Service Provider to Assist a Member in Providing Professional Services,” under Rule 102, Integrity and Objectivity (AICPA, Professional Standards, vol. 2, ET sec. 191 par. 224–225), requires that clients be informed if the firm will outsource professional services to third party service providers. If an audit firm intends to use third party service providers (that is, entities not controlled by the audit firm or individuals not employed by the audit firm), to perform portions of the audit (for example, input tax return information, act as a specialist, or audit an element of the financial statements), the client must be informed before confidential client information is shared with the service provider. If a third party service provider is not used to perform professional services, this paragraph can be omitted.

AICPA Audit and Accounting Manual

AAM §3165.02
indicating there could be a substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time; and (4) other matters as considered necessary or required to be communicated under professional standards.

Assistance to be supplied by your personnel, including the preparation of schedules and analyses of accounts, is described in a separate attachment. Timely completion of this work will facilitate the completion of our audit.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers’ proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

Our fees will be billed as work progresses and are based on the amount of time required plus out of pocket costs and administrative expenses. Invoices are payable upon presentation. Our initial fee estimate assumes we will receive the aforementioned assistance from your personnel and unexpected circumstances will not be encountered. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees, which we estimate to range from $XX,XXX to $XX,XXX. Additional expenses are expected to be $X,XXX.

The audit documentation for this engagement is the property of Lacko, Lynch, Brown & Company and constitutes confidential information. However, we may be requested to make certain audit documentation available to ______________________ [name of regulator] pursuant to authority given to it by law or regulation. If requested, access to such audit documentation will be provided under the supervision of Lacko, Lynch, Brown & Company personnel. Furthermore, upon request, we may provide photocopies of selected audit documentation to ______________________ [name of regulator]. The ______________________ [name of regulator] may intend, or decide, to distribute the photocopies or information contained therein to others, including governmental agencies.

We appreciate the opportunity to serve you and trust that our association will be a long and pleasant one. If you have any questions, please contact us. If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

Sincerely,

LACKO, LYNCH, BROWN & COMPANY

[Engagement Partner’s Signature]

Accepted and agreed to:

[Client Representative’s Signature]

>Title

[Date]
.03 Change in Circumstances From Those Contemplated in Original Engagement Letter

MACARTHUR & KENNEY, CPA’S

[Date]
Mr. James Melakon, Treasurer
Nimbus Country Club
64 Vasily Road
Velikiye Luki, Ohio 10000

Dear Mr. Melakon:

As we agreed in our original engagement letter dated [date] we are notifying you that our audit of your December 31, 20XX financial statements requires additional procedures.

We have found that certain guest checks are held for only three months after they are paid. Thus, a substantial number of guest checks are not available for examination. Fortunately, your internal control activities allow us to use alternative procedures to satisfy ourselves on this part of the audit. However, this will require substantially more time than examining guest checks.

The fee for these additional services will be billed at our standard per diem rates and added to the fees quoted in our previous letter.

The situation has been discussed with your controller, who assured us that in the future all guest checks will be kept for two years.

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

Very truly yours,

MACARTHUR & KENNEY, CPA’S

[Engagement Partner’s Signature]

Accepted and agreed to:

[Client Representative’s Signature]

[Title]

[Date]
.04 Conditions Encountered That Do Not Permit Expression of Opinion as Anticipated in Original Engagement Letter

GEROW, COLLINS & PATCH

[Date]
Mrs. Helene Daestrom, President
Cohrane Manufacturing, Inc.
1234 West Street
Cedar Hill, Tennessee 10000

Dear Mrs. Daestrom:

Our March 15, 20XX letter described our present engagement as an audit for the purpose of expressing an opinion on the financial statements based on our audit. This letter is to inform you that because of the circumstances described below, we will be required to qualify our opinion on these statements.

As you know, the Internal Revenue Service has proposed total income tax assessments of approximately $XXX,XXX for the three fiscal years ended December 31, 20XX. Your tax counsel has advised us that although you have a defensible position and will protest the assessments, counsel cannot offer an opinion as to your ultimate liability. No provision for this assessment or any portion of it is included in your December 31, 20XX financial statements, nor do you feel any is necessary.

Due to an inability to obtain sufficient appropriate audit evidence to support your assertions regarding the tax assessment situation described above, we will be unable to express an unqualified opinion. Our report will state the reasons for the qualification of our opinion.

You and your tax counsel have advised that you will inform us of any new developments in the proposed assessment before our report is issued so that we may consider their effect on your financial statements and on our report.

Sincerely,

GEROW, COLLINS & PATCH

[Engagement Partner’s Signature]

Note:

The client is not asked to sign this letter. Its purpose is to inform the client of the altered circumstances and the effect on the opinion. There is no change in the terms of the engagement. However, it might be desirable to have the client acknowledge receipt of this letter by signing a copy and returning it where—for example—it is a problem, or when there has been a history of misunderstandings.
.05 Audit of Not-for-Profit Financial Statements

LACKO, LYNCH, BROWN & COMPANY
Certified Public Accountants

[Date]
Mr. Matt Smith, President
Not-for-Profit Organization
222 Burnside Highway
Sharpsburg, Maryland 00000

Dear Mr. Smith:

This will confirm our understanding of the services we will provide to Not-for-Profit Organization (the Organization) for the year ending December 31, 20XX.

We will audit the balance sheet of Not-for-Profit Organization as of December 31, 20XX, and the related statements of activities and cash flows for the year then ended, for the purpose of expressing an opinion on them.

Audit Objective

The objective of our audit is the expression of an opinion as to whether your financial statements are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America. Our audit will be conducted in accordance with auditing standards generally accepted in the United States of America and will include tests of accounting records and other procedures we consider necessary to enable us to express such an opinion. If circumstances preclude us from issuing an unqualified opinion, we will discuss the reasons with you in advance. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or decline to issue a report as a result of the engagement.

Audit Procedures

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Accordingly, the areas and number of transactions selected for testing will involve judgment. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

We will plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether from errors or fraud. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. We will inform you of all matters of fraud that come to our attention. We will also inform you of illegal acts that come to our attention, unless they are clearly inconsequential.

Our procedures will include tests of transactions recorded in the accounts, tests of the physical existence of inventory, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected individuals, funding sources, creditors, legal counsel, and financial institutions. At the conclusion of our audit, we will request certain written representations (a “representation letter”) from you about the financial statements and related matters.

3 Some practitioners prefer to include in an engagement letter a clause that would indemnify them against knowing management misrepresentations in jurisdictions where such clauses are permitted. Ethics Ruling No. 94 under AICPA Rule 101 (AICPA, Professional Standards, vol. 2, ET sec. 191 par. 188–189) states that the following indemnification clause in an engagement letter would not impair a CPA’s independence: “The client agrees to release, indemnify, and holds me (us) (and my (our) partners and our heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management.” Auditors of publicly held companies also should consider the applicable Securities and Exchange Commission rules on independence before including an indemnification clause in an engagement letter. Note that the AICPA Professional Ethics Executive Committee is currently addressing the issue of indemnification clauses. Changes to independence rules regarding auditor indemnification and related issues are still pending. Practitioners should be alert to any final guidance.
Because an audit is designed to provide reasonable, but not absolute, assurance and because we will not perform a detailed examination of all transactions, there is a risk that material misstatements or noncompliance may exist and not be detected by us. In addition, an audit is not designed to detect immaterial misstatements, or violations of laws or governmental regulations that do not have a direct and material effect on the financial statements. However, we will inform you and those charged with governance, defined as the person(s) with responsibility for overseeing the strategic direction of the organization and obligations related to the accountability of the organization, including oversight of the financial reporting process, of any material errors and any fraudulent financial reporting or misappropriation of assets that comes to our attention. We will also inform you and those charged with governance of any violations of laws or governmental regulations that come to our attention, unless clearly inconsequential. Our responsibility as auditors is limited to the period covered by our audit and does not extend to matters that might arise during any later periods for which we are not engaged as auditors.

An audit includes obtaining an understanding of the Organization and its environment, including its internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures. An audit is not designed to provide assurance on internal control or to identify deficiencies in internal control. However, we are responsible for communicating to you and those charged with governance internal control related matters that are required to be communicated under Statements on Auditing Standards.

Management Responsibilities

The Organization’s management is responsible for the basic financial statements and all accompanying information as well as all assertions contained therein. Encompassed in that responsibility are the establishment and maintenance of effective internal control over financial reporting; the establishment and maintenance of proper accounting records; the selection of appropriate accounting principles; the safeguarding of assets; fair presentation of the financial statements with generally accepted accounting principles; and compliance with relevant laws and regulations. Management is also responsible for making all financial records and related information available to us and for the accuracy and completeness of that information.

The Organization’s management is responsible for adjusting the financial statements to correct material misstatements and for affirming to us in the representation letter that the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

The Organization’s management is responsible for the design and implementation of programs and controls to prevent and detect fraud and for informing us about all known or suspected fraud affecting the Organization involving management, employees who have significant roles in internal control, and others where the fraud could have a material effect on the financial statements. Management’s responsibilities include informing us of your knowledge of any allegations of fraud or suspected fraud affecting the Organization received in communications from employees, former employees, regulators, or others. In addition, the Organization’s management is responsible for identifying and ensuring that the Organization complies with applicable laws and regulations and for taking timely and appropriate steps to remedy any fraud, illegal acts, or violations of contracts or grant agreements, or abuse that we may report. Management is responsible for making all management decisions and performing all management functions, for designating an individual with suitable skill knowledge, or experience to oversee the tax services or any other nonattest services we provide, and for evaluating the adequacy and results of those services and accepting responsibility for them.

Other Engagement Matters and Limitations

As part of our engagement, we will prepare the Federal Form 990 and [identify other returns] for the year ended [date]. This return will be prepared in accordance with professional standards and may be processed by a contract computer service that has agreed to maintain the confidentiality of all information furnished.
Our work in connection with the preparation of the Form 990 does not include any procedures designed to discover defalcations or other fraud, should any exist.

You have the final responsibility for the Form 990. Therefore, you should review it carefully before you sign and file it.

Professional standards require us to be independent with respect to the Organization in the performance of our services. Any discussions that you have with personnel of our firm regarding employment could pose a threat to our independence. Therefore, we request that you inform us prior to any such discussions so that we can implement appropriate safeguards to maintain our independence. In addition, if you hire one of our personnel, you agree to pay us a fee of [XX] percent of that individual’s base compensation at the Organization, [XX] days from the first day of employment.

Audit Administration, Fees, and Other

We may from time to time, and depending on the circumstances, use third party service providers in serving your account. We may share confidential information about you with these service providers, but remain committed to maintaining the confidentiality and security of your information. Accordingly, we maintain internal policies, procedures, and safeguards to protect the confidentiality of your personal information. In addition, we will secure confidentiality agreements with all service providers to maintain the confidentiality of your information and we will take reasonable precautions to determine that they have appropriate procedures in place to prevent the unauthorized release of your confidential information to others. In the event that we are unable to secure an appropriate confidentiality agreement, you will be asked to provide your consent prior to the sharing of your confidential information with the third party service provider. Furthermore, we will remain responsible for the work provided by any such third party service providers.

Auditing standards generally accepted in the United States of America require that we communicate certain additional matters related to the conduct of our audit to those charged with governance. Such matters include (1) our responsibilities under auditing standards generally accepted in the United States of America; (2) an overview of the planned scope and timing of the audit; (3) significant findings from the audit, including, among others: (a) the initial selection of and changes in significant accounting policies and their application; (b) the process used by management in formulating particularly sensitive accounting estimates and the basis for our conclusions regarding the reasonableness of those estimates; (c) significant difficulties that we encountered in dealing with management related to the performance of the audit; (d) audit adjustments that could, in our judgment, either individually or in the aggregate, have a significant effect on your financial reporting process and uncorrected misstatements of the financial statements that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole; (e) any disagreements with management, whether or not satisfactorily resolved, about matters that individually or in the aggregate could be significant to the financial statements or our report; (f) management representations; (g) our views about matters that were the subject of management’s consultation with other accountants about auditing and accounting matters; (h) major issues that were discussed with management in connection with the retention of our services, including, among other matters, any discussions regarding the application of accounting principles and auditing standards, and if applicable, events or conditions indicating there could be a substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time; and (4) other matters as considered necessary or required to be communicated under professional standards.

Assistance to be supplied by your personnel, including the preparation of schedules and analyses of accounts, is described in a separate attachment. Timely completion of this work will facilitate the completion of our audit.

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4 Ethics Ruling No. 112 under Rule 102 (AICPA, Professional Standards, vol. 2, ET sec. 191 par. 224–225) requires that clients be informed if the firm will outsource professional services to third party service providers. If the an audit firm intends to use third party service providers (that is, entities not controlled by the audit firm or individuals not employed by the audit firm), to perform portions of the audit (for example, input tax return information, act as a specialist, or audit an element of the financial statements), the client must be informed before confidential client information is shared with the service provider. If a third party service provider is not used to perform professional services, this paragraph can be omitted.
If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers’ proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

Our fees will be billed as work progresses and are based on the amount of time required plus out-of-pocket costs and administrative expenses. Invoices are payable upon presentation. Our initial fee estimate assumes we will receive the aforementioned assistance from your personnel and unexpected circumstances will not be encountered. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees, which we estimate to range from $XX,XXX to $XX,XXX. Additional expenses are expected to be $X,XXX.

The audit documentation for this engagement is the property of Lacko, Lynch, Brown & Company and constitutes confidential information. However, we may be requested to make certain audit documentation available to [name of regulator] pursuant to authority given to it by law or regulation. If requested, access to such audit documentation will be provided under the supervision of Lacko, Lynch, Brown & Company personnel. Furthermore, upon request, we may provide photocopies of selected audit documentation to [name of regulator]. The [name of regulator] may intend, or decide, to distribute the photocopies or information contained therein to others, including governmental agencies.

We appreciate the opportunity to serve you and trust that our association will be a long and pleasant one. If you have any questions, please contact us. If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

Sincerely,

LACKO, LYNCH, BROWN & COMPANY

[Engagement Partner’s Signature]

Accepted and agreed to:

[Client Representative’s Signature]

>Title

[Date]
.06 Audit of Not-for-Profit Financial Statements Subject to the Provisions of OMB Circular A-133

LACKO, LYNCH, BROWN & COMPANY
Certified Public Accountants

[Date]
Mr. Matt Cox, President
Not-for-Profit Organization
333 Burnside Highway
Sharpsburg, Maryland 00000

Dear Mr. Cox:

This will confirm our understanding of the services we will provide to Not-for-Profit Organization (the Organization) for the year ending December 31, 20XX.5

We will audit the balance sheet of Not-for-Profit Organization as of December 31, 20XX, and the related statements of activities, changes in partners’ capital, and cash flows for the year then ended, for the purpose of expressing an opinion on them. We also will report on the following additional information accompanying the basic financial statements: (1) schedule of expenditures of federal awards and (2) [insert additional information here].

Audit Objectives

The objective of our audit is the expression of an opinion as to whether your financial statements are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America and to report on the additional information referenced in the second paragraph of this letter when considered in relation to the financial statements taken as a whole.

Our audit will be conducted in accordance with auditing standards generally accepted in the United States of America; the standards for financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; the Single Audit Act Amendments of 1996; and the requirements of OMB Circular A-133, and will include tests of accounting records and other procedures we consider necessary to enable us to express such an opinion and to render the required reports. If circumstances preclude us from issuing an unqualified opinion, we will discuss the reasons with you in advance. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or decline to issue a report as a result of the engagement.

We will also provide a report (that does not include an opinion) on internal control related to the financial statements and compliance with the provisions of applicable laws, regulations, contracts, agreements, and grants, noncompliance with which could have a material effect on the financial statements as required by Government Auditing Standards. The report on internal control and compliance will include a statement that the report is intended solely for the information and use of management, [insert audit committee, if applicable], the board of directors, and specific legislative or regulatory bodies, federal awarding agencies, and if applicable, pass through entities and is not intended to be and should not be used by anyone other than these specified parties. If, during our audit, we become aware that the Company is subject to an audit requirement that is not encompassed in the terms of this engagement, we will communicate to management and those charged with governance that an audit is accordance with auditing standards generally accepted in the United States of America and the standards for financial audits contained in Government Auditing Standards may not satisfy the relevant legal, regulatory, or contractual requirements.

Audit Procedures

5 Note to users of this sample engagement letter: You may add to the engagement letter as appropriate, for additional considerations, such as performing procedures relating to a compliance audit of or limited scope audits of subrecipients, the involvement of other auditors (for example, a joint audit with a minority firm), or the auditee’s responsibility for obtaining the cooperation of the predecessor auditor.
An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Accordingly, the areas and number of transactions selected for testing will involve judgment. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

We will plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether from errors or fraud. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. We will inform you of all matters of fraud that come to our attention. We will also inform you of illegal acts that come to our attention, unless they are clearly inconsequential.6

Our procedures will include tests of transactions recorded in the accounts, tests of the physical existence of inventory, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected individuals, funding sources, creditors, legal counsel, and financial institutions. At the conclusion of our audit, we will request certain written representations (a “representation letter”) from you about the financial statements and related matters.

Because an audit is designed to provide reasonable, but not absolute, assurance and because we will not perform a detailed examination of all transactions, there is a risk that material misstatements or noncompliance may exist and not be detected by us. In addition, an audit is not designed to detect immaterial misstatements or violations of laws or governmental regulations that do not have a direct and material effect on the financial statements. However, we will inform you and those charged with governance, defined as the person(s) with responsibility for overseeing the strategic direction of the organization and obligations related to the accountability of the organization, including oversight of the financial reporting process, of any material errors and any fraudulent financial reporting or misappropriation of assets that comes to our attention. We will also inform you and those charged with governance of any violations of laws or governmental regulations that come to our attention, unless clearly inconsequential. Our responsibility as auditors is limited to the period covered by our audit and does not extend to matters that might arise during any later periods for which we are not engaged as auditors.

As part of our audit of the basic financial statements, we will obtain an understanding of the Organization and its environment, including its internal control, sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of our auditing procedures for the purpose of expressing our opinion on the financial statements. Our audit is not designed to provide an opinion on the [abbreviated name]’s internal control over financial reporting or to identify deficiencies in the design or operation of internal control over financial reporting. However, we are responsible for communicating to you and those charged with governance internal control related matters that are required to be communicated under Statements on Auditing Standards, Government Auditing Standards, and the requirements of OMB Circular A-133.

We also will perform tests of the Organization’s compliance with certain provisions of laws, regulations, and the provisions of contracts or grant agreements. However, it is not our objective to provide an opinion on overall compliance with those provisions and, accordingly, we will not express such an opinion.

In planning the audit, we will follow up on known significant findings and recommendations from previous financial audits, attestation engagements, performance audits, or other studies that directly relate to the objectives of the current audit to determine the effect on our risk assessment and audit procedures.

As part of our audit, we will be alert to situations or transactions that could be indicative of abuse, which involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances. The determination of

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6 Some practitioners prefer to include in an engagement letter a clause that would indemnify them against knowing management misrepresentations in jurisdictions where such clauses are permitted. Ethics Ruling No. 94 under AICPA Rule 101 (AICPA, Professional Standards, vol. 2, ET sec. 191 par. 188–189) states that the following indemnification clause in an engagement letter would not impair a CPA’s independence: “The client agrees to release, indemnify, and holds me (us) (and my (our) partners and our heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management.” Auditors of publicly held companies also should consider the applicable Securities and Exchange Commission rules on independence before including an indemnification clause in an engagement letter. Note that the AICPA Professional Ethics Executive Committee is currently addressing the issue of indemnification clauses. Changes to independence rules regarding auditor indemnification and related issues are still pending. Practitioners should be alert to any final guidance.
abuse is subjective; Government Auditing Standards does not expect us to provide reasonable assurance of
detecting abuse, and we will not design the audit to detect abuse. However, if we become aware of indications
of material abuse, we will apply procedures to ascertain whether abuse has occurred.

A schedule of expenditures of federal awards will accompany the Organization’s basic financial statements.
We will subject that schedule to the audit procedures applied in our audit of the basic financial statements
and render our opinion on whether that schedule is fairly presented, in all material respects, in relation to the
basic financial statements taken as a whole. We also will make specific inquiries of management about that
schedule, which management will affirm to us in its representation letter.

Management Responsibilities

The Organization’s management is responsible for the basic financial statements and the schedule of
expenditures of federal awards as well as all assertions contained therein. Encompassed in that responsibility
are the establishment and maintenance of effective internal control over financial reporting; the establishment
and maintenance of proper accounting records; the selection of appropriate accounting principles; the
safeguarding of assets; and the identification of and compliance with laws, regulations, and the provisions of
contracts or grant agreements. Management is responsible for making all financial records and related
information available to us and for the accuracy and completeness of that information. Management also is
responsible for adjusting the basic financial statements to correct material misstatements and for affirming to
us in its representation letter that the effects of any uncorrected misstatements that we accumulate during the
current audit and pertaining to the latest period presented are immaterial, both individually and in the
aggregate, to the basic financial statements.

The Organization’s management is responsible for the design and implementation of programs and controls
to prevent and detect fraud and for informing us about all known or suspected fraud or illegal acts affecting
the Organization involving management, employees who have significant roles in internal control, and others
where the fraud or illegal acts could have a material effect on the financial statements. Management’s
responsibilities include informing us of your knowledge of any allegations of fraud or suspected fraud or
illegal acts affecting the Organization received in communications from employees, former employees,
regulators, or others.

You are responsible for making all management decisions and performing all management functions, for
designating an individual with suitable skill knowledge, or experience to oversee the tax services or any other
nonattest services we provide, and for evaluating the adequacy and results of those services and accepting
responsibility for them.

Compliance Audit of Federal Programs

The Organization’s management is responsible for compliance with laws, regulations, and the provisions of
contracts or grant agreements related to federal programs. Encompassed in that responsibility is the estab-
lishment and maintenance of internal control over compliance that provides reasonable assurance that the
Organization is managing federal awards in compliance with laws, regulations, and provisions of contracts
or grant agreements.

Our responsibility is to express an opinion on whether the Organization complied with the types of
compliance requirements described in the OMB Circular A-133 Compliance Supplement that could have a direct
and material effect on each of the Organization’s major federal programs. Following the criteria for federal
program risk in OMB Circular A-133, we will determine which federal programs should be considered major
programs and thus included within the scope of the compliance audit.7

We will plan and perform the audit to obtain reasonable assurance about whether noncompliance with the
types of compliance requirements that are applicable to the Organization’s major federal programs could have
a direct and material effect on each of its major federal programs. An audit of compliance includes examining,
on a test basis, evidence about the Organization’s compliance with those requirements and performing such

7 Note to users of this sample engagement letter: This paragraph may be modified if the auditor elects to use a dollar threshold approach
to selecting major programs, as allowed by A-133 for first-year single audits.

AICPA Audit and Accounting Manual

AAM §3165.06
other procedures we consider necessary in the circumstances. Our audit does not provide a legal determi-
nation on the Organization’s compliance with those requirements.

As part of our audit of compliance applicable to the Organization’s major federal programs, we will obtain
an understanding of the Organization’s internal control over compliance sufficient to assess the risks of
material misstatement of the financial statements whether due to error or fraud and to design the nature,
timing, and extent of our auditing procedures for the purpose of expressing our opinion on compliance and
not to provide assurance on the internal control over compliance. We also will perform testing of internal
control as required by OMB Circular A-133. We are responsible for communicating to you and those charged
with governance internal control related matters that are required to be communicated under AICPA
professional standards, Government Auditing Standards, and the requirements of OMB Circular A-133.

We also will follow up on prior audit findings by performing procedures to assess the reasonableness of the
Organization’s summary schedule of prior audit findings.

We will include in our reports information about the following, if any: material noncompliance with laws,
regulations, and provisions of contracts or grant agreements related to major programs; certain known
questioned costs; fraud affecting federal awards; abuse that is material to a federal program; and other federal
award audit findings as required by Government Auditing Standards and OMB Circular A-133.

Other Communications Arising From the Audit

In connection with planning and performing our audit, we will communicate certain matters to appropriate
Organization’s personnel and to those charged with governance, including our responsibilities for testing and
reporting on internal control over financial reporting and on compliance with laws, regulations, and
provisions of contracts or grant agreements, both for our financial statement audit and our compliance audit
of major federal programs. We also will communicate certain matters of interest, as applicable, to the audit
committee, including changes in significant accounting policies or their application, adjustments arising from
the audit that could either individually or in the aggregate have a significant effect on the Organization’s
financial reporting process, and fraud involving senior management that is not otherwise included in our
reports.

Auditing standards generally accepted in the United States of America require that we communicate certain
additional matters related to the conduct of our audit to those charged with governance. Such matters include
(1) our responsibilities under auditing standards generally accepted in the United States of America; (2) an
overview of the planned scope and timing of the audit; (3) significant audit findings, including, among others:
(a) the initial selection of and changes in significant accounting policies and their application; (b) the process
used by management in formulating particularly sensitive accounting estimates and the basis for our
conclusions regarding the reasonableness of those estimates; (c) serious difficulties that we encountered in
dealing with management related to the performance of the audit; (d) audit adjustments that could, in our
judgment, either individually or in the aggregate, have a significant effect on your financial reporting process
and uncorrected misstatements of the financial statements that were determined by management to be
immaterial, both individually and in the aggregate, to the financial statements taken as a whole; (e) any
disagreements with management, whether or not satisfactorily resolved, about matters that individually or
in the aggregate could be significant to the financial statements or our report; (f) management representa-
tions; (g) our views about matters that were the subject of management’s consultation with other accountants about
auditing and accounting matters; (h) major issues that were discussed with management in connection with
the retention of our services, including, among other matters, any discussions regarding the application of
accounting principles and auditing standards, and if applicable, events or conditions indicating there could
be a substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time;
and (4) other matters as considered necessary or required to be communicated under professional standards.

In planning and performing our audit, we will ask management, those charged with governance, the internal
auditor, and others within the entity about fraud or suspected fraud; allegations of fraud or

8 Note to users of this sample engagement letter: Government Auditing Standards paragraphs 4.08–.09 specify the parties to whom this
communication should be made.
suspected fraud; the risks of fraud; programs and controls established to prevent and detect fraud; whether management has communicated information about those programs and controls to those charged with governance; and how management communicates to employees its views on business practices and ethical behavior.

We also may communicate in a management letter certain matters identified during the audit or possible ways to improve the Organization’s operational efficiency and effectiveness or otherwise improve its internal control or other policies or procedures. Under GAAS and Government Auditing Standards, we also may be required to directly report fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse to outside parties.

**Other Engagement Matters and Limitations**

As part of our engagement, we will prepare the Federal Form 990 [and identify other returns] for the year ended [date]. This return will be prepared in accordance with professional standards and may be processed by a contract computer service that has agreed to maintain the confidentiality of all information furnished.

Our work in connection with the preparation of Form 990 does not include any procedures designed to discover defalcations or other fraud, should any exist.

You have the final responsibility for the Form 990. Therefore, you should review it carefully before you sign and file it.

Professional standards require us to be independent with respect to the [abbreviated name] in the performance of our services. Any discussion that you have with personnel of our firm regarding employment could pose a threat to our independence. Therefore, we request that you inform us prior to any such discussions so that we can implement appropriate safeguards to maintain our independence. In addition, if you hire one of our personnel, you agree to pay us a fee of [XX] percent of that individual’s base compensation at the [abbreviated name], [XX] days from the first day of employment.

**Audit Administration, Fees, and Other**

We may from time to time, and depending on the circumstances, use third party service providers in serving your account. We may share confidential information about you with these service providers, but remain committed to maintaining the confidentiality and security of your information. Accordingly, we maintain internal policies, procedures, and safeguards to protect the confidentiality of your personal information. In addition, we will secure confidentiality agreements with all service providers to maintain the confidentiality of your information and we will take reasonable precautions to determine that they have appropriate procedures in place to prevent the unauthorized release of your confidential information to others. In the event that we are unable to secure an appropriate confidentiality agreement, you will be asked to provide your consent prior to the sharing of your confidential information with the third party service provider. Furthermore, we will remain responsible for the work provided by any such third party service providers.9

The Organization agrees to make available to us all records, documentation, and information we request in connection with our audit, to disclose to us all material information, and to give to us the full cooperation of the Organization’s personnel. An enclosure to this letter describes the assistance to be supplied by Organization personnel, including preparation of schedules and analyses of accounts, and the timing for that assistance. Timely completion of that work will facilitate the conclusion of our audit.

The Organization agrees to provide us printer’s proofs of its basic financial statements, schedule of expenditures of federal awards, and other information for its Circular A-133 reporting package for our review and approval before printing. The [abbreviated name] also agrees to provide us with a copy of the final reproduced material for our approval before distributing it.

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9 Ethics Ruling No. 112 under Rule 102 (AICPA, Professional Standards, vol. 2, ET sec. 191 par. .224–.225) requires that clients be informed if the firm will outsource professional services to third party service providers. If the an audit firm intends to use third party service providers (that is, entities not controlled by the audit firm or individuals not employed by the audit firm), to perform portions of the audit (for example, input tax return information, act as a specialist, or audit an element of the financial statements), the client must be informed before confidential client information is shared with the service provider. If a third party service provider is not used to perform professional services, this paragraph can be omitted.
The Organization also is responsible for:

- Taking timely and appropriate steps to remedy fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that we report.
- Having a process to track the status of audit findings and recommendations.
- Identifying for us previous financial audits, attestation engagements, performance audits, or other studies related to the objectives of our audit and the corrective actions taken to address significant findings and recommendations.
- Providing its views on our current findings, conclusions, and recommendations, as well as management’s planned corrective actions, for our reports. The corrective action plan that the Organization develops for its OMB Circular A-133 reporting package may fully or partially satisfy this responsibility.

Our reports on the Organization’s internal control and compliance will state that they are intended solely for the information and use of those charged with governance, management, federal awarding agencies, and pass-through entities and are not intended to be and should not be used by anyone other than these specified parties. However, the Organization should make copies of our reports available for public inspection unless they are restricted by law or regulation, or contain privileged and confidential information.

The documentation for this audit is our firm’s property and constitutes confidential information. We will maintain that documentation for the minimum period of time required by applicable auditing standards and requirements. In accordance with Government Auditing Standards, OMB Circular A-133, and federal law, we may be required, upon request, to make certain of that documentation (including photocopies) available to other auditors or reviewers, including the cognizant or oversight agency for audit or its designee, a federal agency providing direct or indirect funding, and the U.S. Government Accountability Office. Those parties may intend, or decide, to distribute the photocopies or information contained therein to others, including other governmental agencies and the public. We will notify you of any such requests.

Our firm undergoes a periodic external peer review that examines the quality of our auditing practice. We are enclosing with this letter a copy of the report and letter of comment from our firm’s most recent external peer review.

We are always available to meet with you or other executives at various times throughout the year to discuss current business, operational, accounting, and auditing matters affecting the Organization. Whenever you feel such meetings are desirable, please let us know. We also are prepared to provide services to assist you in any of these areas. We also will be pleased, at your request, to attend your directors’ meetings.

If the Organization wishes to assert that it complied, in all material respects, with specified laws and regulations, we could perform an engagement in accordance the American Institute of Certified Public Accountants’ and Government Auditing Standards’ attestation standards. The procedures we would perform would be more limited than if we were to express an opinion on management’s assertions.

Our fee estimate, which is shown in a separate schedule, is based on a “core” amount for the financial statement audit and tax return preparation services plus an incremental amount for the compliance audit of federal programs, based on the Organization’s actual number of major programs.\(^1\) We also will charge the Organization for our out-of-pocket expenses. We will bill our fees as work progresses with payment to be made upon presentation. Our initial fee estimate and our target date for delivering our reports assume that we will receive the aforementioned assistance from Organization personnel and that we will not encounter unexpected circumstances. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of fees or our report delivery date, which is on or about [date]. Prior to the release of the audit reports, we will require payment of 100 percent of all fees billed.

\(^1\) Note to users of this sample engagement letter: Various factors may change the level of effort required for the compliance audit of federal programs from year-to-year. For example, the auditee may have more or fewer federal programs or major programs because of new or discontinued federal programs, increased or decreased federal funding for existing programs, and OMB changes in program clusters, or the auditee may achieve or lose low risk auditee status. As shown in this sample letter, auditors could consider pricing their services for the compliance audit based on the number of major programs to be audited.
Our charges for other services will be agreed to separately.

The arrangements described in this letter will be updated annually.

Sincerely,

LACKO, LYNCH, BROWN & COMPANY

[Engagement Partner’s Signature]

Accepted and agreed to:

[Client Representative’s Signature]

[Title]

[Date]

Attachments: Required assistance from [Name of Client] personnel; peer review report and letter of comment for the CPA firm’s most recent peer review; fee schedule.
Audit of Financial Institution Financial Statements

LACKO, LYNCH, BROWN & COMPANY
Certified Public Accountants

[Date]
Mr. Matt Cox, President
Financial Institution
333 Burnside Highway
Sharpsburg, Maryland 00000

Dear Mr. Smith:

We are pleased to confirm our understanding of the services we are to provide for Financial Institution (the “Bank”) for the year ended December 31, 20XX.

We will audit the balance sheet of Financial Institution as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended.

The objective of our audit is the expression of an opinion about whether your financial statements are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America. Our audit will be conducted in accordance with auditing standards generally accepted in the United States of America and will include tests of your accounting records and other procedures we consider necessary to enable us to express such an opinion. If our opinion is other than unqualified, we will discuss the reasons with you in advance. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or to issue a report as a result of this engagement.

Our procedures will include tests of documentary evidence and other procedures supporting the transactions recorded in the accounts. We will also request written representations from your attorneys as part of the engagement, and they may bill you for responding to this inquiry. At the conclusion of our audit, we will require certain written representations from you about the financial statements and related matters.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; therefore, our audit will involve judgment about the number of transactions to be examined and the areas to be tested. We will plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether from (a) errors, (b) fraudulent financial reporting, (c) misappropriation of assets, or (d) violations of laws or governmental regulations that are attributable to the entity or to acts by management or employees acting on behalf of the entity. Because an audit is designed to provide reasonable, but not absolute, assurance and because we will not perform a detailed examination of all transactions, there is a risk that material misstatements may exist and not be detected by us. In addition, an audit is not designed to detect immaterial misstatements or violations of laws or governmental regulations that do not have a direct and material effect on the financial statements. However, we will inform you of any material errors that come to our attention, and we will inform you of any fraudulent financial reporting or misappropriation of assets that comes to our attention. We will also inform you of any violations of laws or governmental regulations that come to our attention, unless clearly inconsequential. Our responsibility as auditors is limited to the period covered by our audit and does not extend to any later periods for which we are not engaged as auditors.

Our audit will include obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed. An audit is not designed to provide assurance on internal control or to identify deficiencies in internal control. However, during the audit, we will communicate to you internal control related matters that are required to be communicated under professional standards.

In accordance with auditing standards promulgated by the AICPA, we will communicate certain matters related to the conduct and results of the audit to those charged with governance. Such matters include, when
applicable, disagreements with management, whether or not resolved; serious difficulties encountered in performing the audit; our level of responsibility under auditing standards promulgated by the AICPA for the financial statements, for internal control, and for other information in documents containing the audited financial statements; unrecorded audit differences that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements as a whole; changes in the Bank’s significant accounting policies and methods for accounting for significant unusual transactions or for controversial or emerging areas; our judgments about the quality of the Bank’s accounting principles; our basis for conclusions as to sensitive accounting estimates; management’s consultations, if any, with other accountants; and major issues discussed with management prior to our retention.

Management of the Bank is responsible for apprising us of all allegations involving financial improprieties received by management or those charged with governance (regardless of the source or form and including, without limitation, allegations by “whistle-blowers”), and providing us full access to these allegations and any internal investigations of them, on a timely basis. Allegations of financial improprieties include allegations of manipulation of financial results by management or employees, misappropriation of assets by management or employees, intentional circumvention of internal controls, inappropriate influence on related party transactions by related parties, intentionally misleading Lacko, Lynch, Brown & Company (“LLBC”), or other allegations of illegal acts or fraud that could result in a misstatement of the financial statements or otherwise affect the financial reporting of the Bank. If the Bank limits the information otherwise available to us under this paragraph (based on the Bank’s claims of attorney/client privilege, work product doctrine, or otherwise), the Bank will immediately inform us of the fact that certain information is being withheld from us. Any such withholding of information could be considered a restriction on the scope of the audit and may prevent us from opining on the Bank’s financial statements; alter the form of report we may issue on such financial statements; or otherwise affect our ability to continue as the Bank’s independent auditors. The Bank and we will disclose any such withholding of information to those charged with governance.

In accordance with FDIC regulations, we, as your auditors, are required to make the following commitments: The audit documentation for this engagement is the property of LLBC and constitutes confidential information. However, we may be requested to make certain attest documentation available to the FDIC or any other applicable Federal or state banking agency pursuant to authority given to it by law or regulation. If requested, access to such audit documentation will be provided under the supervision of LLBC personnel. Furthermore, upon request, we may provide copies of selected audit documentation to the FDIC or other applicable Federal or state banking agency. The FDIC or other applicable Federal or state banking agency may intend, or decide, to distribute the copies or information contained therein to others, including other governmental agencies.

We may from time to time, and depending on the circumstances, use third-party service providers in serving your account. We may share confidential information about you with these service providers, but remain committed to maintaining the confidentiality and security of your information. Accordingly, we maintain internal policies, procedures, and safeguards to protect the confidentiality of your personal information. In addition, we will secure confidentiality agreements with all service providers to maintain the confidentiality of your information and we will take reasonable precautions to determine that they have appropriate procedures in place to prevent the unauthorized release of your confidential information to others. In the event that we are unable to secure an appropriate confidentiality agreement, you will be asked to provide your consent prior to the sharing of your confidential information with the third-party service provider. Furthermore, we will remain responsible for the work provided by any such third-party service providers.

You are responsible for establishing and maintaining internal controls, including monitoring ongoing activities; for the selection and application of accounting principles; and for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America. You are also responsible for management decisions and functions; for designating an individual with suitable skill, knowledge, or experience to oversee the tax services and any other nonattest services we provide; and for evaluating the adequacy and results of those services and accepting responsibility for them.

You are responsible for making all financial records and related information available to us and for the accuracy and completeness of that information. Your responsibilities include adjusting the financial statements to correct material misstatements and confirming to us in the management representation letter that
the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

You are responsible for the design and implementation of programs and controls to prevent and detect fraud, and for informing us about all known or suspected fraud affecting the Bank involving (a) management, (b) employees who have significant roles in internal control, and (c) others where the fraud could have a material effect on the financial statements. Your responsibilities include informing us of your knowledge of any allegations of fraud or suspected fraud affecting the Bank received in communications from employees, former employees, regulators, or others. In addition, you are responsible for identifying and ensuring that the entity complies with applicable laws and regulations.

With regard to the electronic dissemination of audited financial statements, including financial statements published electronically on your Internet website, you understand that electronic sites are a means to distribute information and, therefore, we are not required to read the information contained in these sites or to consider the consistency of other information in the electronic site with the original document.

You should be aware that certain communications involving tax advice between you and members of our firm who are authorized tax practitioners or their agents may be privileged from disclosure to the IRS. The privilege may be waived, however, by voluntarily disclosing the contents of those communications to a third party. The privileged information might be used by you in preparing your financial statements and, consequently, disclosed to us in auditing those statements. In addition, professional standards require us to discuss matters that may affect the audit with our firm personnel responsible for tax services, who may disclose the privileged information to us. The IRS might take the position that such communication results in a waiver of privilege.

In the unlikely event that differences concerning LLBC’s services or fees should arise that are not resolved by mutual agreement, to facilitate judicial resolution and save time and expense of both parties, the Bank and LLBC agree not to demand a trial by jury in any action, proceeding or counterclaim arising out of or relating to LLBC’s services and fees for this engagement and agree to submit to voluntary mediation.

Attached hereto is a copy of a letter that we will request your principal officers to sign at the commencement of our audit. It sets forth, in summary fashion, our respective responsibilities with respect to your financial statements and our audit thereof.

We understand that your employees will prepare all confirmations we request and will locate any documents selected by us for testing. All confirmations will be prepared as of September 30, 20XX, with the exception of legal council and investment confirmations. We expect to begin our audit during October 20XX. Please note that we are required under accounting regulations to issue our report as close to the audit opinion date as possible. We expect the majority of the documentation necessary to perform our audit to be available at the date of fieldwork commencement mentioned above. Our audit engagement ends on delivery of our audit report. We expect to provide you with a final draft of the Bank’s audited financial statements on January 16, 20XX, given that we have been provided by management the first draft by January 4, 20XX. Any follow-up services that might be required will be a separate, new engagement. The terms and conditions of that new engagement will be governed by a new, specific engagement letter for that service. We will also prepare the Bank’s tax returns for the year ended December 31, 20XX.

We estimate that our fees for these services will range from $______ to $______ for the audit and $______ for the tax return. You will also be billed for travel and other out-of-pocket costs such as report production, word processing, postage, etc. The fee estimate is based on anticipated cooperation from your personnel and the assumption that unexpected circumstances will not be encountered during the audit. If significant additional time is necessary, we will discuss it with you and arrive at a new fee estimate before we incur the additional costs. Our invoices for these fees will be rendered each month as work progresses and are payable on presentation. In accordance with our firm policies, work may be suspended if your account becomes 30 days or more overdue and will not be resumed until your account is paid in full. If we elect to terminate our services for nonpayment, our engagement will be deemed to have been completed upon written notification of termination, even if we have not completed our report. You will be obligated to compensate us for all time expended and to reimburse us for all out-of-pocket expenditures through the date of termination.
You may request that we perform additional services not addressed in this engagement letter. If this occurs, we will communicate with you regarding the scope of the additional services and the estimated fees. We also may issue a separate engagement letter covering the additional services. In the absence of any other written communication from us documenting such additional services, our services will continue to be governed by the terms of this engagement letter.

In the event we are requested or authorized by the Bank or are required by government regulation, subpoena, or other legal process to produce our documents or our personnel as witnesses with respect to our engagements for the Bank, the Bank will, so long as we are not a party to the proceeding in which the information is sought, reimburse us for our professional time and expenses, as well as the fees and expenses of our counsel, incurred in responding to such requests.

This engagement letter is contractual in nature, and includes all of the relevant terms that will govern the engagement for which it has been prepared. The terms of this letter supersede any prior oral or written representations or commitments by or between the parties. Any material changes or additions to the terms set forth in this letter will only become effective if evidenced by a written amendment to this letter, signed by all the parties.

We appreciate the opportunity to be of service to you and believe this letter accurately summarizes the significant terms of our engagement. If you have any questions, please let us know. If you agree with the terms of our engagement as described in this letter, please sign the enclosed copy and return it to us.

Very truly yours,

LACKO, LYNCH, BROWN & COMPANY

[Engagement Partner’s Signature]

For the Firm

RESPONSE:

This letter correctly sets forth the understanding of Financial Institution.

[Signature]

[Title]

[Date]

[The next page is 4001.]
The material included in these sections on internal control is presented for illustrative purposes only. The comments and illustrations are neither all inclusive nor are they prescribed minimums. They are intended as conveniences for users of this manual who may want assistance when developing materials to meet their individual needs.

This manual is a nonauthoritative kit of practice aids and, accordingly, these sections on internal control do not include extensive explanation or discussion of authoritative pronouncements. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate.

### TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>4100 Introduction</td>
<td>.01-.05</td>
</tr>
<tr>
<td>Overview</td>
<td>.01-.05</td>
</tr>
<tr>
<td>4200 Internal Control Framework</td>
<td>.01-.140</td>
</tr>
<tr>
<td>Introduction</td>
<td>.01-.13</td>
</tr>
<tr>
<td>Effect of Information Technology on Internal Control</td>
<td>.14-.21</td>
</tr>
<tr>
<td>Focus on the Small Business Entity</td>
<td>.22-.23</td>
</tr>
<tr>
<td>Controls Relevant to Reliable Financial Reporting and to the Audit</td>
<td>.24-.30</td>
</tr>
<tr>
<td>Internal Control Components</td>
<td>.31-.78</td>
</tr>
<tr>
<td>Understanding the Control Environment</td>
<td>.31-.55</td>
</tr>
<tr>
<td>Risk Assessment</td>
<td>.56-.59</td>
</tr>
<tr>
<td>Control Activities</td>
<td>.60-.68</td>
</tr>
<tr>
<td>Information and Communication Systems</td>
<td>.69-.76</td>
</tr>
<tr>
<td>Monitoring</td>
<td>.77-.78</td>
</tr>
<tr>
<td>Application to Medium and Large Businesses</td>
<td>.79-.86</td>
</tr>
<tr>
<td>Board of Directors or Audit Committee</td>
<td>.80-.82</td>
</tr>
<tr>
<td>Internal Audit Function</td>
<td>.83-.85</td>
</tr>
<tr>
<td>Formal Policies</td>
<td>.86</td>
</tr>
<tr>
<td>Computer Applications</td>
<td>.87-.102</td>
</tr>
<tr>
<td>Acquisition of Hardware and Software</td>
<td>.90-.99</td>
</tr>
<tr>
<td>User Controls Over Computer Service Organization Applications</td>
<td>.100-.102</td>
</tr>
<tr>
<td>Application to Medium or Large Businesses</td>
<td>.103-.111</td>
</tr>
<tr>
<td>Obtaining an Understanding of Significant Account Balances and Transaction Cycles</td>
<td>.112-.127</td>
</tr>
<tr>
<td>Segregation of Duties and Management Override</td>
<td>.128-.136</td>
</tr>
<tr>
<td>Assessing Internal Control Strengths and Weaknesses</td>
<td>.137-.140</td>
</tr>
</tbody>
</table>

[The next page is 4101.]
AAM Section 4100

Introduction

Overview

.01 As discussed in AAM section 3125, the auditor should obtain an understanding of the 5 components of internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures. A sufficient understanding means the auditor should perform risk assessment procedures to evaluate the design of controls relevant to an audit and to determine whether they have been implemented. In obtaining this understanding, the auditor should consider how an entity’s use of IT and manual procedures may affect controls relevant to the audit.

.02 AU section 314, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (AICPA, Professional Standards, vol. 1), provides a framework to help the auditor obtain an understanding of internal control. This framework breaks internal control into 5 components as identified in paragraph .03 of AAM section 4200. The division of internal control into the 5 components provides a useful framework for auditors to consider how different aspects of an entity’s internal control may affect the audit.

.03 The auditor’s understanding of internal control is used to

- identify types of potential misstatement;
- consider factors that affect the risks of material misstatement;
- design tests of controls, when applicable; and
- design substantive procedures.

.04 The auditor’s understanding of a client’s internal control should be based on previous experience with the client and the following:

- Inquiries of appropriate management, supervisory, and staff personnel
- Analytical procedures
- Inspection of documents and records
- Observation of the entity’s activities and operations

.05 AAM section 4200 provides more detail on the internal control framework described in AU section 314. Refer to AAM section 5100 for guidance pertaining to the design of further audit procedures (tests of controls or substantive procedures, or both) and AAM section 5200 for specific guidance on the performance of tests of controls.

[The next page is 4201.]
AAM Section 4200

Internal Control Framework

Introduction

.01 As described in AAM section 3125, AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), provides a framework to help the auditor obtain an understanding of internal control. That framework is built on 2 concepts: objectives and components.

.02 An *objective* is what the entity is trying to achieve. Generally, an entity tries to achieve objectives in the following three categories:

- Reliability of financial reporting
- Effectiveness and efficiency of operations
- Compliance with applicable laws and regulations

.03 For each of these objectives, internal control consists of the following five interrelated components:

- **Control environment**, which sets the tone of an organization and influences the control consciousness of its people. It is the foundation for all other components of internal control and provides discipline and structure.
- **Risk assessment**, which is the entity’s identification and analysis of relevant risks to achievement of its objectives. It forms a basis for determining how the risks should be managed.
- **Control activities**, which are the policies and procedures that help ensure management directives are carried out.
- **Information and communication systems**, which support the identification, capture, and exchange of information in a form and time frame that enables people to carry out their responsibilities.
- **Monitoring**, which is a process that assesses the quality of internal control performance over time.

.04 Although an entity’s internal control addresses objectives referred to in paragraph .02, not all of these objectives and related controls are relevant to an effective audit of an entity’s financial statements. Ordinarily, controls that are relevant to an audit pertain to the entity’s objective of preparing financial statements that are fairly presented in conformity with generally accepted accounting principles (GAAP), including the management of risk that may give rise to a risk of material misstatement in those financial statements. An entity may have controls that relate to operations and compliance with laws and regulations that are not relevant to an audit and, therefore, need not be considered.

.05 The Jones family owns and operates several neighborhood grocery stores in Anytown. The bank reconciliation performed by the Jones Grocery controller is an example of a control that relates primarily to the financial reporting objective. Jones also has an inventory tracking and management system that allows each store manager to track inventory levels and order new items before they run out of stock. This control activity is part of the operations objective. Each store has a small deli that prepares sandwiches and some hot foods. These food preparation activities must comply with state health laws and regulations, and Jones has policies in place to help ensure that those laws and regulations are met. Those policies are directed at the compliance objective of the entity.

.06 The controls having to do with the ordering of inventory or compliance with state health laws and regulations are important to Jones Grocery but ordinarily will not relate to the audit of the company’s financial statement. If you
were the auditor of Jones Grocery, you may wish to ask about and document these controls for client service or other purposes, but because these controls are not relevant to the audit, you are not required to do so.

.07 However, if controls relating to operations and compliance objectives pertain to data the auditor evaluates or uses in applying auditing procedures, then they may be relevant to the audit.

.08 For example, the financial reporting system may produce a sales report by inventory stock number for each sales region. If the auditor decided to use information from this report when auditing the proper valuation of inventory, he or she might obtain an understanding of the following:

- Which transactions or classes of transactions are included in the report
- How significant accounting data about those transactions are entered into and flow through the financial reporting system
- What files are processed
- What nature of processing is involved in producing the report

.09 Controls relating to operations and compliance objectives may, however, be relevant to an audit if they pertain to information or data the auditor may evaluate or use in applying audit procedures. For example, controls pertaining to nonfinancial data that the auditor may use in analytical procedures, such as production statistics, or controls pertaining to detecting noncompliance with laws and regulations that may have a direct and material effect on the financial statements, such as controls over compliance with income tax laws and regulations used to determine the income tax provision, may be relevant to an audit.

.10 Internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives. In obtaining an understanding of each of the components of internal control, the auditor’s consideration of safeguarding controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

.11 The internal control framework described in AU section 314 is only a means to help the auditor consider the impact of an entity’s internal control in an audit. The auditor’s primary consideration is whether, and how, a specific control prevents or detects and corrects material misstatements in relevant assertions related to classes of transactions, account balances, or disclosures, rather than its classification into any particular component. Controls relevant to the audit are those that individually or in combination with others are likely to prevent or detect material misstatements in financial statement assertions. Such controls may exist in any of the 5 components.

.12 Suppose you are the auditor of Jones Grocery. As on all audits, you should obtain an understanding of internal control sufficient to assess the risks of material misstatement and to design the nature, timing, and extent of further audit procedures. To achieve this, you organize your inquiries and other procedures to understand each of the five components of internal control that relate to the financial reporting objectives. As a result of performing your procedures, you discover the client’s bank reconciliation procedures. Should a bank reconciliation be considered a “control procedure”? What about the fact that someone follows up and investigates old or unusual reconciling items? Is that considered a “monitoring” activity?

.13 These questions are rhetorical because the issue of how to classify a particular control is irrelevant for your purposes. As an auditor, your primary consideration is to understand how the bank reconciliations, whether individually or in combination with other controls, affect financial statement assertions relating to cash.
Effect of Information Technology on Internal Control

.14 An entity’s use of IT may affect any of the five components of internal control relevant to the achievement of the entity’s financial reporting, operations, or compliance objectives and its operating units or business functions. For example, an entity may use IT as part of discrete systems that support only particular business units, functions, or activities, such as a unique accounts receivable system for a particular business unit or a system that controls the operation of factory equipment. Alternatively, an entity may have complex, highly integrated systems that share data and that are used to support all aspects of the entity’s financial reporting, operations, and compliance objectives.

.15 The use of IT also affects the fundamental manner in which transactions are initiated, authorized, recorded, processed, and reported. In a manual system, an entity uses manual procedures and records in paper format (for example, individuals may manually record sales orders on paper forms or journals, authorize credit, prepare shipping reports and invoices, and maintain accounts receivable records). Controls in such a system also are manual and may include such procedures as approvals and reviews of activities, reconciliations, and follow-ups of reconciling items. Alternatively, an entity may have information systems that use automated procedures to initiate, authorize, record, process, and report transactions, in which case records in electronic format replace such paper documents as purchase orders, invoices, shipping documents, and related accounting records. Controls in systems that use IT consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions. When IT is used to initiate, authorize, record, process, or report transactions or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or may be critical to the effective functioning of manual controls that depend on IT. An entity’s mix of manual and automated controls varies with the nature and complexity of the entity’s use of IT.

.16 IT provides potential benefits of effectiveness and efficiency for an entity’s internal control because it enables an entity to

- consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- enhance the timeliness, availability, and accuracy of information;
- facilitate the additional analysis of information;
- enhance the ability to monitor the performance of the entity’s activities and its policies and procedures;
- reduce the risk that controls will be circumvented; and
- enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

.17 IT also poses specific risks to an entity’s internal control, including

- reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both;
- unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or nonexistent transactions or inaccurate recording of transactions;
- unauthorized changes to data in master files;
- unauthorized changes to systems or programs;
• failure to make necessary changes to systems or programs;
• inappropriate manual intervention; and
• potential loss of data or inability to access data as required.

.18 The extent and nature of these risks to internal control vary depending on the nature and characteristics of the entity’s information system. For example, multiple users, either external or internal, may access a common database of information that affects financial reporting. In such circumstances, a lack of control at a single user entry point might compromise the security of the entire database, potentially resulting in improper changes to or destruction of data. When IT personnel or users are given, or can gain, access privileges beyond those necessary to perform their assigned duties, a breakdown in segregation of duties can occur. This could result in unauthorized transactions or changes to programs or data that affect the financial statements. Therefore, the nature and characteristics of an entity’s use of IT in its information system affect the entity’s internal control.

.19 Manual controls of systems may be more suitable where judgment and discretion are required, such as for the following circumstances:
• Large, unusual, or nonrecurring transactions
• Circumstances where misstatements are difficult to define, anticipate, or predict
• In changing circumstances that require a control response outside the scope of an existing automated control
• In monitoring the effectiveness of automated controls

.20 Manual controls are performed by people and, therefore, pose specific risks to the entity’s internal control. Manual controls may be less reliable than automated controls because they can be more easily bypassed, ignored, or overridden and they are also more prone to errors and mistakes. Consistency of application of a manual control element cannot, therefore, be assumed. Manual systems may be less suitable for the following:
• High volume or recurring transactions, or in situations in which errors that can be anticipated or predicted can be prevented or detected by control parameters that are automated
• Control activities in which the specific ways to perform the control can be adequately designed and automated

.21 The purpose of this section is to provide guidance on each of the five components that comprise the internal control framework. This guidance may help the auditor perform procedures to obtain an understanding of internal control. These procedures generally include the following steps:
• Understand internal control components that have a pervasive effect on the organization
• Understand how IT is used to process significant accounting information
• Understand control activities for significant account balances or transaction cycles
• Assess the risk of management override and lack of segregation of duties

Focus on the Small Business Entity

.22 This section emphasizes the audit of a small business entity. Small business entities are typically characterized by
• a single owner or a small group of owners who manage the business on a day to day basis;
• a small number of employees involved in the accounting function;
• no outside board of directors or internal audit function; and
• the use of off-the-shelf, unmodified computer software or the use of an outside computer service organization to process significant accounting information.

.23 This section provides some guidance for the audits of medium to large businesses.

Controls Relevant to Reliable Financial Reporting and to the Audit

.24 There is a direct relationship between an entity’s objectives and the internal control components it implements to provide reasonable assurance about their achievement. In addition, internal control is relevant to the entire entity or to any of its operating units or business functions. Although the entity’s objectives and, therefore, controls relate to financial reporting, operations, and compliance, not all of these objectives and controls are relevant to the audit. Further, although internal control applies to the entire entity, or to any of its operating units or business functions, an understanding of internal control relating to each of the entity’s operating units and business functions may not be necessary to the performance of the audit.

.25 Ordinarily, controls that are relevant to an audit pertain to the entity’s objective of preparing financial statements that are fairly presented in conformity with GAAP, including the management of risk that may give rise to a risk of material misstatement in those financial statements. However, it is not necessary to assess all controls in connection with assessing the risks of material misstatement and designing and performing further audit procedures in response to assessed risks. It is a matter of the auditor’s professional judgment as to the controls or combination of controls that should be assessed. However, as stated in paragraph .115 of AU section 314, for significant risks—to the extent the auditor has not already done so—the auditor should evaluate the design of the entity’s related controls, including relevant control activities, and determine whether they have been implemented. In exercising that judgment, the auditor should consider the circumstances, the applicable component, and factors such as the following:

• Materiality
• The size of the entity
• The nature of the entity’s business, including its organization and ownership characteristics
• The diversity and complexity of the entity’s operations
• Applicable legal and regulatory requirements
• The nature and complexity of the systems that are part of the entity’s internal control, including the use of service organizations

.26 Controls over the completeness and accuracy of information produced by the entity may also be relevant to the audit if the auditor intends to make use of the information in designing and performing further audit procedures. The auditor’s previous experience with the entity and information obtained in understanding the entity and its environment and throughout the audit assist the auditor in identifying controls relevant to the audit.

.27 Controls relating to operations and compliance objectives may, however, be relevant to an audit if they pertain to information or data the auditor may evaluate or use in applying audit procedures. For example, controls pertaining to nonfinancial data that the auditor may use in analytical procedures, such as production statistics, or controls pertaining to detecting noncompliance with laws and regulations that may have a direct and material effect on the financial statements, such as controls over compliance with income tax laws and regulations used to determine the income tax provision, may be relevant to an audit.

.28 An entity generally has controls relating to objectives that are not relevant to an audit and, therefore, need not be considered. For example, an entity may rely on a sophisticated system of automated controls to

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1 An auditor may need to consider controls relevant to compliance objectives when performing an audit in accordance with AU section 801, Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance (AICPA, Professional Standards, vol. 1).

AICPA Audit and Accounting Manual  
AAM §4200.28
provide efficient and effective operations (such as a manufacturing plant’s computerized production scheduling system), but these controls ordinarily would not be relevant to the audit.

.29 Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives. In obtaining an understanding of each of the components of internal control, the auditor’s consideration of safeguarding controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

.30 Controls relevant to the audit may exist in any of the components of internal control and a further discussion of controls relevant to the audit is included in paragraphs .67–.101 of AU section 314. In addition, paragraphs .115 and .117 of AU section 314 discuss certain risks for which the auditor should evaluate the design of the entity’s controls over such risks and determine whether they have been implemented.

Internal Control Components
Understanding the Control Environment

.31 The control environment sets the tone of an organization. It influences the control consciousness of its people and is the foundation for all other components of internal control. In obtaining an understanding of the client’s control environment, the auditor should obtain sufficient knowledge to understand the attitudes, awareness, and actions of those charged with governance concerning the entity’s internal control and its importance in achieving reliable financial reporting. In understanding the control environment, the auditor should concentrate on the implementation of controls because controls may be established but not acted upon. The following paragraphs describe some factors the auditor should consider when evaluating a client’s control environment.

.32 Integrity and ethical values. The effectiveness of internal control cannot rise above the integrity and ethical values of the owner-manager. Integrity and ethical values are essential elements of the control environment because they affect the design, administration, and monitoring of other internal control components.

.33 Management may tell you a great deal about their integrity and ethical values. They may even commit their words to a written document. Responses to inquiries and written policies are good, but compliance with ethical standards is best ensured by focusing on management’s actions and how these actions affect the entity on a day to day basis.

.34 For management’s integrity and ethical values to have a positive effect on the entity, the following ordinarily should exist:

- The business owner and management should personally have high ethical and behavioral standards.
- These standards should be communicated to company personnel. In a small business, this communication is often informal.
- The standards should be reinforced.

.35 When observing and evaluating management’s actions be alert for the following:

- Segregation of personal from business funds and activities. Many small business owners mix their personal and business activities, for example, the company may pay the owner’s credit card bills even if they contain nonbusiness expenditures. The auditor might consider the owner’s attitude and the care with which he or she separates the personal from the business activities. It’s not unusual for a business to pay the owner’s credit card bills, but the more important question is “does the owner reimburse the
company?” Owners who treat company assets as if they were personal assets set a bad example for employees who may be encouraged to do the same.

- **Dealing with signs of problems.** Consider how management deals with signs that problems exist, particularly when the cost of identifying and solving the problem could be high. For example, suppose a client became aware of a possible environmental contamination on their premises. How would they react? Would they try to hide it, deny its existence, or act evasively if asked about it, or would they actively seek out their auditor’s advice or the advice of their attorney?

- **Removal or reduction of incentives and temptations.** Individuals may engage in dishonest, illegal, or unethical acts simply because the owner-manager gives them strong incentives or temptations to do so. Removing or reducing these incentives and temptations can go a long way toward diminishing undesirable behavior.

The emphasis on results, particularly in the short term, fosters an environment in which the price of failure becomes very high. **Incentives** for engaging in fraudulent or questionable financial reporting practices include the following:

- Pressure to meet unrealistic performance targets, particularly for short term results
- High performance-dependent rewards
- Upper and lower cutoffs on bonus plans

**Temptations** for employees to engage in improper practices include the following:

- Nonexistent or ineffective controls, such as poor segregation of duties in sensitive areas that offer temptations to steal or conceal questionable financial reporting practices
- Owner-managers who are unaware of actions taken by employees
- Penalties for improper behavior that are insignificant or unpublicized and thus lose their value as deterrents

- **Management intervention.** There are certain situations where it is appropriate for management to intervene and overrule prescribed policies or procedures for legitimate purposes. For example, management intervention is usually necessary to deal with nonrecurring and nonstandard transactions or events that otherwise might be handled by the financial reporting information system. The auditor might consider whether management has provided guidance on the situations and frequency with which intervention of established controls is appropriate. It is a best practice for management interventions to be documented and explained.

.36 **Commitment to competence.** Competence reflects the knowledge and skills necessary to accomplish tasks that define an individual’s job. Commitment to competence includes management’s consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

.37 **Mrs. Jones has always kept the books for Jones Grocery. She is self-taught, with no formal training in accounting or bookkeeping. There are no plans to replace Mrs. Jones with someone more “qualified.”** As the auditor of Jones Grocery you recognized the risk of having an untrained bookkeeper and design your audit approach to address such concerns by

- training Mr. and Mrs. Jones to call you whenever they have a transaction out of the ordinary;
- strongly encouraging Mrs. Jones to take training classes on her accounting software package (she has);
- explaining to Mrs. Jones the importance of key accounting records such as the accounts payable subledger and inventory reports; and
- teaching Mrs. Jones important basic control functions such as bank reconciliations.

.38 **Management’s philosophy and operating style.** Management’s philosophy and operating style encompass a broad range of characteristics. Such characteristics may include

- the owner-manager’s approach to taking and managing business risks;
attitudes and actions toward financial reporting and tax matters; and

attitudes and actions toward information processing and accounting functions and personnel.

Management’s philosophy and operating style have a significant influence on the control environment, particularly in a small business where the owner-manager dominates the organization, regardless of the consideration given to the other control environment factors. For example, the auditor may be concerned about the client’s unduly aggressive attitude toward financial reporting. Not only might this cause the auditor to assess control risk as high for some or all assertions, but it may heighten concerns about irregularities affecting certain assertions.

However, a dominant owner-manager does not necessarily cause the auditor to assess control risk as high.

Mr. Jones dominates the management of Jones Grocery. He demonstrates a positive attitude toward the control environment and a moderate to conservative attitude toward accepting business risk such as expansion. He is more concerned about taxes than financial reporting. Mr. Jones uses information generated by the financial reporting information system to monitor the financial results of the company and compare it to prior periods. His review of the accounting reports encourages Mrs. Jones and others who help with the accounting to work with greater care. Mr. Jones also performs many control activities himself, such as the review and supervision of the physical inventory counts. Although Mr. Jones is concerned about his income tax liability, you might not view the possible bias to misstate income as a significant risk because of the otherwise positive control environment.

Organizational structure. A client’s organizational structure provides the framework within which its activities for achieving entity-wide objectives are planned, executed, controlled, and reviewed.

Significant aspects of establishing an organizational structure include considering key areas of authority and responsibility and appropriate lines of reporting. Small business entities usually have fairly simple organizational structures. A highly structured organization with formal reporting lines and responsibilities may be appropriate for large entities, but for a small business, this type of structure may impede the necessary flow of information.

Assignment of authority and responsibility. The assignment of authority and responsibility includes, among other things, the following:

- The establishment of reporting relationships and authorization procedures
- The degree to which individuals and groups are encouraged to use initiative in addressing issues and solving problems
- The establishment of limits of authority
- Policies describing appropriate business practices
- Resources provided for carrying out duties

Alignment of authority and accountability often is designed to encourage individual initiatives, within limits. Delegation of authority means surrendering central control of certain business decisions to lower echelons to the people who are closest to everyday business transactions.

A critical challenge is to delegate only to the extent required to achieve objectives. This requires ensuring that risk acceptance is based on sound practices for identifying and minimizing risk, including sizing risks and weighing potential losses versus gains in arriving at good business decisions.

Another challenge is ensuring that all personnel understand the entity’s objectives. It is essential that each individual knows how his or her actions interrelate and contribute to achievement of the objectives.
Mr. Jones had to decide how to delegate authority and responsibility when he expanded Jones Grocery from the one original store to its present eight store chain spread out over greater Anytown and the surrounding suburbs. One area that proved problematic was setting prices. Mr. Jones assumed that he would be able to set the prices at all of the stores, just like he did for his original store. He felt this was a good procedure because it allowed him some control over profit margins. Problems arose because the competitive pressures were different in different areas of the city. A competitor in the north suburb ran specials or lowered prices on certain items, and a competitor in the west suburb ran specials on different items. It became too difficult for Mr. Jones to keep up with the constantly changing price battles at eight different stores. He eventually delegated this responsibility to the individual store managers. He set a limit on how much a store manager could discount prices without his prior approval, but other than that, the store managers had the freedom to set prices to respond to the changing competitive environment.

The responsibility for accounting information was also affected by Jones Grocery’s expansion. Mr. Jones’ original thought was that each store would be run as a separate business, with separate financial reporting information systems that would be consolidated together at the main store. Problems soon developed in several areas, most notably accounts payable. The store managers were responsible for entering vendor invoices into the computer system. But it seemed that no matter how much Mr. Jones threatened, cajoled, and begged his store managers to enter the invoices on a timely basis, they just couldn’t do it consistently. The procedure had to be changed. Now, the store managers only have the responsibility to check incoming goods for quantity and condition. Vendor invoices are sent directly to Mrs. Jones at the main store, and she is responsible for maintaining the accounts payable for all the stores.

The control environment is greatly influenced by the extent to which individuals recognize that they will be held accountable. This holds true all the way to the owner-manager, who has the ultimate responsibility for all activities within the organization, including internal control.

Human resource policies and practices. Human resource policies and practices affect an entity’s ability to employ sufficient competent personnel to accomplish its goals and objectives. Human resource policies and practices include an entity’s policies and procedures for hiring, orienting, training, evaluating, counseling, promoting, compensating, and taking remedial action. In many small businesses, the policies may not be formalized but they can nevertheless exist and be communicated. The owner-manager can orally make explicit his or her expectations about the type of person to be hired to fill a particular job and may even be active in the hiring process. Formal documentation is not always necessary for a policy to be in place and operating effectively.

When Mr. and Mrs. Jones added a second store, the hiring of a store manager was easy—they hired their daughter. Adding a third store proved to be more problematic, because the other Jones children had no interest in the family business. Mr. and Mrs. Jones talked at length about the type of person they would hire as a store manager. They finally decided it was more important to hire someone they could trust, someone they felt comfortable with on a personal level rather than someone with an extensive background in the grocery business. They felt they could teach someone the grocery business but not how to be trustworthy. That hiring policy worked, and they’ve been following it ever since.

Standards for hiring the most qualified individuals, with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior, demonstrate an entity’s commitment to competent and trustworthy people. Hiring practices that include formal in-depth employment interviews and informative and insightful presentations on the company’s history, culture, and operating style send a message that the company is committed to its people.

Personnel policies that communicate prospective roles and responsibilities and that provide training opportunities indicate expected levels of performance and behavior. Rotation of personnel and promotions driven by periodic performance appraisals demonstrate the entity’s commitment to advancement of qualified personnel to higher levels of responsibility. Competitive compensation programs that include bonus incentives serve to motivate and reinforce outstanding performance. Disciplinary actions send a message that violations of expected behavior will not be tolerated.

Participation of those charged with governance. An entity’s control consciousness is significantly influenced by those charged with governance. As defined in paragraph .03 of AU section 380, The Auditor’s Communication...
With Those Charged With Governance (AICPA, Professional Standards, vol. 1), those charged with governance means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. In some cases, those charged with governance are responsible for approving the entity’s financial statements (in other cases management has this responsibility). For entities with a board of directors, this term encompasses the terms board of directors or audit committee. For small business entities, those charged with governance may not include any independent or outside members. Please refer to the following paragraphs .80–.82 for additional discussion of how the participation of those charged with governance applies to medium and large businesses.

Risk Assessment

.56 An entity’s risk assessment process for financial reporting purposes is its identification, analysis, and management of risks relevant to the preparation of reliable financial statements in conformity with GAAP. For example, risk assessment may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions.

.57 Risks relevant to financial reporting include events and circumstances that may adversely affect the company’s ability to initiate, authorize, record, process, and report financial data consistent with the assertions of management in the financial statements. Once risks are identified, management considers their significance, the likelihood of their occurrence, and how they should generally be managed. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations.

.58 Risks can arise or change due to circumstances such as the following:

- Changes in the operating environment. Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- New personnel. New personnel may have a different focus on or understanding of internal control. When people change jobs or leave the company, management generally should consider the control activities they performed and who will perform them going forward. Steps ordinarily should be taken to ensure new personnel understand their tasks.
- New or revamped information systems. Significant and rapid changes in information systems can change the risk relating to internal control. When these systems are changed, management generally should assess how the changes will impact control activities. Are the existing activities appropriate or even possible with the new systems? Personnel should be adequately trained when information systems are changed or replaced.
- Rapid growth. Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls. Management generally should consider whether accounting and information systems are adequate to handle increases in volume.
- New technology. Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- New business models, products, or activities. Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- Corporate restructurings. Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- Expanded foreign operations. The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control (for example, additional or changed risks from foreign currency transactions).
- New accounting pronouncements. Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.
.59 The auditor’s procedures to assess whether a risk assessment process is placed in operation are generally of an inquiry nature. For example, you may ask accounting personnel what accounts they believe are the most difficult to become satisfied with as they prepare the financial statements. You may also consider asking the same questions of personnel outside the accounting department.

Control Activities

.60 Control activities are policies and procedures that help ensure that management directives are carried out. For example, necessary actions are taken to address risks to achieve the entity’s objectives. Control activities, whether automated or manual, have various objectives and are applied at various organizational and functional levels.

.61 At the entity-wide level, control activities may be categorized as policies and procedures that pertain to the following:

- **Performance reviews.** These control activities include reviews of actual performance versus budgets, forecasts, and prior period performance. They may also involve relating different sets of data (for example, operating or financial) to one another, together with analyses of the relationships, investigating unusual relationships and taking corrective action. Performance reviews may also include a review of functional or activity performance.

- **Information processing.** A variety of controls are performed to check accuracy, completeness, and authorization of transactions. The two broad groupings of information systems control activities are application controls and general controls. Application controls apply to the processing of individual applications. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. General controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. General controls commonly include controls over data center and network operations; system software acquisition, change, and maintenance; access security; and application system acquisition, development, and maintenance. These controls apply to mainframe, miniframe, and end user environments. Examples of such general controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail. These controls are discussed in more detail in the following paragraphs .87–.91.

- **Physical controls.** These activities encompass the physical security of assets, including adequate safeguards over access to assets and records such as secured facilities and authorization for access to computer programs and data files and periodic counting and comparison with amounts shown on control records. The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation and, therefore, the audit depends on circumstances such as when assets are highly susceptible to misappropriation. For example, these controls would ordinarily not be relevant when inventory losses would be detected pursuant to periodic physical inspection and recorded in the financial statements. However, if for financial reporting purposes management relies solely on perpetual inventory records, the physical security controls would be relevant to the audit.

- **Segregation of duties.** Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of his or her duties. Segregation of duties is often a problem for small business entities. See the following paragraphs .128–.136 for further discussion and guidance.

.62 You should consider the knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control in determining whether it is necessary to devote
additional attention to obtaining an understanding of control activities. An audit does not require an understanding of all the control activities related to each class of transactions, account balance, and disclosure in the financial statements or to every relevant assertion. Ordinarily, control activities that may be relevant to an audit include those relating to authorization, segregation of duties, safeguarding of assets, and asset accountability, including, for example, reconciliations of the general ledger to the detailed records. The auditor should obtain an understanding of the process of reconciling detail to the general ledger for significant accounts.

.63 In obtaining an understanding of control activities, the auditor’s primary consideration is whether, and how, a specific control activity, individually or in combination with others, prevents or detects and corrects material misstatements in classes of transactions, account balances, or disclosures. Control activities relevant to the audit are those for which the auditor considers it necessary to obtain an understanding in order to assess risks of material misstatement at the assertion level and to design and perform further audit procedures responsive to the assessed risks. The auditor’s emphasis is on identifying and obtaining an understanding of control activities that address the areas where you consider that material misstatements are more likely to occur. When multiple control activities achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to that objective.

.64 The auditor should obtain an understanding of how IT affects control activities that are relevant to planning the audit. Some entities and auditors may view the IT control activities in terms of application controls and general controls. Application controls apply to the processing of individual applications. Accordingly, application controls relate to the use of IT to initiate, authorize, record, process, and report transactions or other financial data. These controls help ensure that transactions have occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data, numerical sequence checks, and manual follow-up of exception reports.

.65 Application controls may be performed by IT (for example, automated reconciliation of subsystems) or by individuals. When application controls are performed by people interacting with IT, they may be referred to as user controls. The effectiveness of user controls, such as reviews of computer produced exception reports or other information produced by IT, may depend on the accuracy of the information produced. For example, a user may review an exception report to identify credit sales over a customer’s authorized credit limit without performing procedures to verify its accuracy. In such cases, the effectiveness of the user control (that is, the review of the exception report) depends on both the effectiveness of the user review and the accuracy of the information in the report produced by IT.

.66 General controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. General controls commonly include controls over data center and network operations; system software acquisition, change, and maintenance; access security; and application system acquisition, development, and maintenance. Though ineffective general controls do not, by themselves, cause misstatements, they may permit application controls to operate improperly and allow misstatements to occur and not be detected. For example, if there are weaknesses in the general controls over access security, and applications are relying on these general controls to prevent unauthorized transactions from being processed, such a general control weakness may have a more severe effect on the effective design and operation of the application control. General controls should be assessed in relation to their effect on applications and data that become part of the financial statements. For example, if no new systems are implemented during the period of the financial statements, weaknesses in the general controls over systems development may not be relevant to the financial statements being audited.

.67 The use of IT affects the way that control activities are implemented. For example, when IT is used in an information system, segregation of duties often is achieved by implementing security controls.

.68 The auditor should consider whether the entity has responded adequately to the risks arising from IT by establishing effective controls, including effective general controls upon which application controls
depend. From the auditor’s perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process.

Information and Communication Systems

.69 An information system consists of infrastructure (physical and hardware components), software, people, procedures (manual and automated), and data. Infrastructure and software will be absent, or have less significance, in systems that are exclusively or primarily manual. Many information systems make extensive use of IT. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, authorize, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. Transactions may be initiated manually or automatically by programmed procedures. Authorization includes the process of approving transactions by the appropriate level management. Recording includes identifying and capturing the relevant information for transactions or events. Processing includes functions such as edit and validation, calculation, measurement, valuation, summarization, and reconciliation, whether performed by automated or manual procedures. Reporting relates to the preparation of financial reports as well as other information, in electronic or printed format, that the entity uses in measuring and reviewing the entity’s financial performance and in other functions.

.70 The quality of system generated information affects management’s ability to make appropriate decisions in controlling the entity’s activities and to prepare reliable financial statements. Thus, it is important that management receives the information they need to carry out their responsibilities and that the information is provided at the right level of detail. Accordingly, an information system encompasses procedures and records that

- identify and record all valid transactions;
- describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting;
- measure the value of transactions in a manner that permits recording of their proper monetary value in the financial statements;
- determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period; and
- present properly the transactions and related disclosures in the financial statements.

.71 The financial reporting information system is an integral part of an entity’s information and communication system. The auditor’s consideration of the system is often made at the individual account and classes of transaction level. See the following paragraphs .112–.127 for additional guidance.

.72 Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Open communication channels help ensure that exceptions are reported and acted on. Communication takes such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

.73 The auditor should obtain sufficient knowledge of the information system, including the related business processes relevant to financial reporting, to understand

- the classes of transactions in the entity’s operations that are significant to the financial statements;
- the procedures, both automated and manual, by which transactions are initiated, authorized, recorded, processed, and reported from their occurrence to their inclusion in the financial statements;
the related accounting records, whether electronic or manual, supporting information, and specific accounts in the financial statements involved in initiating, authorizing, recording, processing, and reporting transactions;

how the information system captures other events and conditions that are significant to the financial statements; and

the financial reporting process used to prepare the entity’s financial statements, including significant accounting estimates and disclosures.

.74 When IT is used to initiate, authorize, record, process, or report transactions or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for significant accounts or may be critical to the effective functioning of manual controls that depend on IT.

.75 The auditor also should obtain an understanding of how the incorrect processing of transactions is resolved. For example, such understanding might include whether there is an automated suspense file, how it is used by the entity to ensure that suspense items are cleared out on a timely basis, and how system overrides or bypasses to controls are processed and accounted for.

.76 In obtaining an understanding of the financial reporting process (including the closing process), the auditor should understand the automated and manual procedures an entity uses to prepare financial statements and related disclosures, and how misstatements may occur. Such procedures include the following:

- **Entering transaction totals into the general ledger (or equivalent record).** In some information systems, IT may be used to automatically transfer such information from transaction processing systems to general ledger or financial reporting systems. The automated processes and controls in such systems may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or financial reporting system. Furthermore, in planning the audit, the auditor should be aware that when IT is used to automatically transfer information there may be little or no visible evidence of such intervention in the information systems.

- **Initiating, authorizing, recording, and processing journal entries in the general ledger.** An entity’s financial reporting process used to prepare the financial statements typically includes the use of standard journal entries that are required on a recurring basis to record transactions such as sales, purchases, and cash disbursements or to record accounting estimates that are periodically made by management such as changes in the estimate of uncollectible accounts receivable. An entity’s financial reporting process also includes the use of nonstandard journal entries to record nonrecurring or unusual transactions or adjustments such as a business combination or disposal, or a nonrecurring estimate such as an asset impairment. In manual, paper-based general ledger systems, such journal entries may be identified through inspection of ledgers, journals, and supporting documentation. However, when IT is used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may be more difficult to identify through the use of computer assisted techniques.

- **Initiating and recording recurring and nonrecurring adjustments to the financial statements.** These are procedures relating to adjustments and reclassifications that are not reflected in formal journal entries.

- **Combining and consolidating general ledger data.** This includes procedures to combine detailed general ledger accounts, prepare the trial balance, and prepare consolidated financial data (for example, transferring general ledger data and adjusting journals into a consolidation system or spreadsheet; performing consolidation routines; and reconciling and reviewing consolidated financial data, including footnote data).

- **Preparing financial statements and disclosures.** These are procedures designed to ensure that information required to be presented and disclosed is accumulated, recorded, processed, summarized, and appropriately reported in the financial statements.
Monitoring

.77 Monitoring is a process that assesses the quality of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions.

.78 Examples of ongoing monitoring activities include the following:

- Management reviews of data produced by the entity’s information system. Managers are in touch with operations and may question reports that differ significantly from their knowledge of operations. However, management generally should have a basis for believing the data is accurate. If errors exist in the information, management may make incorrect conclusions from its monitoring activities.
- Communications from external parties corroborate internally generated information or indicate problems. Customers implicitly corroborate billing data by paying their invoices. Conversely, customer complaints about billings could indicate system deficiencies in the processing of sales transactions. Similarly, bankers, regulators, or other outside parties may communicate with the company on matters of accounting significance.
- External auditors regularly provide recommendations on the way internal control can be strengthened. Auditors may identify potential weaknesses and make recommendations to management for corrective action.
- Employees may be required to sign off to evidence the performance of critical control functions. The sign-off allows management to monitor the performance of these control functions.

Application to Medium and Large Businesses

.79 The control environments of medium to large businesses may differ from those of small business entities in the following ways:

- The presence of a board of directors or audit committee
- The presence of an internal audit function
- More formalized policies and procedures

Board of Directors or Audit Committee

.80 The control consciousness of a medium or large business is influenced significantly by those charged with governance. As defined previously, those charged with governance means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. Those charged with governance encompasses the term board of directors and audit committee used elsewhere in this section. Because of its importance, an active and involved board of directors—possessing an appropriate degree of management, technical, and other expertise coupled with the necessary stature and mind-set so that it can adequately perform the necessary governance, guidance, and oversight responsibilities—is critical to effective internal control.

.81 Factors that influence the effectiveness of those charged with governance include the following:

- Its independence from management
- The experience and stature of its members
- The extent of its involvement and scrutiny of activities
- The appropriateness of its actions
- The degree to which difficult questions are raised and pursued with management
- Its interaction with internal and external auditors
The board of directors must be prepared to question and scrutinize management’s activities, present alternative views and have the courage to act in the face of obvious wrongdoing. Because of this, it is necessary that the board contain at least a critical mass of outside directors. The number should suit the entity’s circumstances, but more than one outside director normally would be needed for a board to have the requisite balance.

**Internal Audit Function**

The internal audit function is established within an entity to monitor and evaluate the adequacy and effectiveness of internal control. For entities with an internal audit function, the auditor ordinarily should make inquiries of appropriate management and internal audit personnel about the internal auditors’

- organizational status within the entity;
- application of professional standards;
- audit plan, including the nature, timing, and extent of audit work; and
- access to records and any limitations on the scope of their activities.

After obtaining an understanding of the internal audit function, the auditor may either

- conclude that the internal auditors’ activities are not relevant to the financial statement audit and give no further consideration to the internal audit function;
- identify relevant internal auditor activities but conclude that it would not be efficient to consider further the work of the internal auditors; or
- decide that it would be efficient to consider how the internal auditors’ work might affect the nature, timing, and extent of the audit. In this case, you should assess the competence and objectivity of the internal audit function as outlined in AU section 322, The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements (AICPA, Professional Standards, vol. 1).

You may also request direct assistance from the internal auditors. Paragraph .27 of AU section 322 establishes requirements and provides guidance for auditors when using internal auditors to provide direct assistance in performing the audit.

**Formal Policies**

Medium and large businesses may communicate their policies in formal, written documents. For example, they may have a written code of conduct or human resource policies. The existence of formal policy documents is good, but as an auditor, your primary consideration is how the policies are implemented.

**Computer Applications**

Small business entities are typically characterized by the use of off the shelf, unmodified computer software or the use of an outside computer service organization to process significant accounting information.

Jones Grocery has a stand-alone, state-of-the-art PC at its main store. One other store has a computer—an Apple Macintosh that Mr. and Mrs. Jones’ daughter used at college. The PC at the main store is used to run the accounting software, which is an off the shelf product developed specifically for independent grocers. The payroll is processed by an outside payroll service.

In gaining an understanding of how computers are used in the business, the auditor may consider the following:

- The acquisition of hardware and software
- Physical access
• Logical access
• User controls over outsider service bureau applications

Acquisition of Hardware and Software

.90 Companies ordinarily should take steps to ensure they have compatible hardware and software. The use of compatible software reduces the risk of error, because there will be no need to transfer data from one format into another. Even small businesses generally should have a coherent plan for the purchase of computer hardware and software. If the business is growing, management will typically plan for the upgrade of the processor, random access memory (RAM), or hard disk storage.

.91 Mr. and Mrs. Jones did not plan for the purchase of their computers. For several years, Mrs. Jones processed the accounting applications on an old PC with limited RAM and hard-disk storage. When the Jones’ daughter opened the second store, she brought with her the Apple Macintosh she had in college. At first, she tried to transfer data from her store to the main store, but the software had problems converting from the Apple format, so the procedure was abandoned. At a trade show, Mr. Jones discovered a computer software program specifically designed for independent grocers. He was impressed with the program and decided that it fit his needs perfectly. However, his hardware was out of date, and so in order to run the software, he upgraded his hardware. The new software supposedly is able to handle Apple-formatted data, and the company has plans to transfer data from the second store electronically. There are no plans to install computers at the other stores.

.92 As the auditor of Jones Grocery, you should use this understanding of the company computer system to help plan the audit. For example, they plan to transfer data from the Apple to the PC. What other sorts of errors might occur in the transfer? What steps has the client taken to prevent or detect those errors? You also know that stores three through eight are on a manual system. What types of errors might occur in a manual system? What is the risk that those errors will occur?

.93 Entities ordinarily should also establish policies and procedures to mitigate the risk of computer viruses being introduced into their systems. Viruses can cause the loss of data and programs. A virus has the ability to attach itself to a program and infect other programs and systems. Although some viruses merely write messages across the screen, others can cause serious damage to disk files or shut down a network by replicating themselves millions of times and filling all available memory or disk storage.

.94 Methods to prevent the introduction of viruses and to recover from a virus attack include the following:
• Obtaining recognized software from reputable sources and only accepting delivery of the software in the manufacturer’s sealed package.
• Making multiple generations of backups. A virus that is not detected initially may be copied onto more recent backup copies, and the older versions may not be infected.
• Prohibiting the use of unauthorized programs introduced by employees.
• Prohibiting the downloading of untested software from sources such as dial-up bulletin boards.
• Using virus protection software to screen for virus infections.

Physical Security

.95 Physical security—primarily backup and contingency planning—often is ignored by small businesses in a microcomputer environment. Poor backup procedures can result in the loss of important data that are very difficult, time consuming, and costly to recreate, if they can be recreated at all.

.96 Clients generally should have established procedures for the periodic backup of data files and applications. Critical applications and files ordinarily should be stored off-site with corresponding documentation in the event that on-site files become unavailable.
Logical Access

.97 Logical access to computer applications and data files may not be formally or rigorously controlled in a small business. This leaves the company exposed to the risk that files could be inappropriately manipulated or unauthorized transactions entered into the system. For example, without logical access controls a user may be able to enter any or all sections of a general ledger or other financial module and perform file maintenance such as changing the address of an accounts receivable customer or data used to calculate payroll.

.98 Management ordinarily should identify confidential and sensitive data for which access should be restricted. Mechanisms such as password control or the use of menus can be used to limit the access to that data.

.99 In a microcomputer environment, password control may be installed over the operating system using a shell program to prevent the user from accessing menu options of a program. Even if such a restriction exists, a sophisticated user can often bypass the shell by using a utility. Therefore, the use of utility programs generally should be controlled or monitored carefully.

User Controls Over Computer Service Organization Applications

.100 Entities may use an outside computer service organization to process significant accounting information. AU section 324, Service Organizations (AICPA, Professional Standards, vol. 1), establishes requirements and provides guidance for auditors auditing entities that use computer service organizations.

.101 When using an outside computer service organization, most small businesses typically retain the responsibility for authorizing transactions and maintaining the related accountability. The computer service organization merely records user transactions and processes the related data. In these circumstances, the user (the small business) typically maintains controls over the input and output to prevent or detect material misstatement. When the service organization initiates, executes, and does the accounting processing of the user organization’s transactions, it may not be practicable for the user organization to implement effective controls for those transactions.

.102 Jones Grocery uses an outside computer service to process payroll. Time cards are gathered for each store and reviewed by the store manager before being sent to the main store. Mrs. Jones reviews the time cards for the store managers and checks to make sure all personnel have submitted time cards for the pay period. All other payroll transactions such as pay rates, withholdings, and benefits, among others, are sent directly to Mrs. Jones. She forwards all information to the payroll service, which prepares the checks and produces a payroll register. Mrs. Jones reviews the register and checks for any obvious misstatements before she distributes the checks.

Application to Medium or Large Businesses

.103 Medium and large businesses typically have more complicated computer processing systems than small businesses. They also tend to use the computer for a greater amount of processing. For example, a small business may prepare customer invoices manually by looking up prices on a master price list. A medium size business may maintain master price information on a computer file and use the computer to generate packing slips, sales invoices, and reports of unmatched documents.

.104 Medium and large businesses are also typically characterized by a separate management information services department with formally defined job descriptions and responsibilities.

.105 Instead of using off the shelf, unmodified software, the medium or large business will modify standard software or develop its own applications. Its software may be more complicated than that used by the small business; for example, the medium or large business may use a database management system or telecommunications software.
Medium and large businesses often use a mainframe computer in conjunction with microcomputers or a local area microcomputer network. Information is frequently transferred between the mainframe and microcomputers that may be located on-site or at a remote location.

Control activities in a computerized environment generally comprise a combination of the following:
- User control activities
- Programmed control activities and manual follow-up
- Computer general control activities

User controls. User control activities are manual checks of the completeness and accuracy of computer output against source documents or other input. For example, an entity may have programmed procedures in a billing system that calculate sales invoice amounts from shipping data and master price files. The entity may also have a procedure to manually check the completeness and accuracy of the invoices. In many systems, user controls relate only to the completeness of records and not to the accuracy of processing.

Programmed control activities and manual follow-up activities. Programmed control activities are those that are built into the computer processing program; for example, the generation of an exception report. However, an exception report is useless unless the client follows up on the items listed. Thus, in addition to understanding the nature of the programmed control activities, the auditor may also obtain an understanding of the related manual follow-up procedures.

Computer general control activities. If computer general control activities operate effectively, there is greater assurance that programmed control activities are properly designed and function consistently throughout the period. The auditor may plan to understand computer general control activities to provide evidence that
- programs are properly designed and tested in development;
- changes to programs are properly made;
- computer operations ensure the proper use of application programs and data files; and
- adequate access controls reduce the risk of unauthorized changes to the program and data files.

The following table summarizes computer general control activities.

<table>
<thead>
<tr>
<th>Area</th>
<th>Control Objectives</th>
<th>Example Controls</th>
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<tbody>
<tr>
<td>Program development</td>
<td>• Controls ensure that new applications systems are suitably authorized, designed, and tested</td>
<td>• Users are involved in the design and approval of systems</td>
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<td></td>
<td></td>
<td>• Checkpoints where users review the completion of various phases of the application</td>
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<td></td>
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<td>• Development of test data and testing of the program</td>
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<td></td>
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<td>• User involvement in the review of tests of the program</td>
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<td>• Adequate procedures to transfer programs from development to production libraries</td>
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(continued)
Obtaining an Understanding of Significant Account Balances and Transaction Cycles

.112 As discussed in paragraph .83 of AU section 314, the auditor should obtain sufficient knowledge of the information system, including the related business processes relevant to financial reporting to understand

- the classes of transactions in the entity’s operations that are significant to the financial statements;
- the procedures, both automated and manual, by which transactions are initiated, authorized, recorded, processed, and reported from their occurrence to their inclusion in the financial statements;
- the related accounting records, whether electronic or manual, supporting information, and specific accounts in the financial statements involved in initiating, recording, processing, and reporting transactions;
- how the information system captures other events and conditions that are significant to the financial statements; and
- the financial reporting process used to prepare the entity’s financial statements, including significant accounting estimates and disclosures.

.113 Accounting processing. In obtaining an understanding of how a client processes accounting information—from the initiation of the transaction to its inclusion in the financial statements—the auditor may focus on how the computer is used to process data and the ways in which transactions are valued, classified, and summarized in data files, journals, or ledgers. For some transactions, there may be several
significant processing activities and accounting records, including the use of computer programs. Other
transactions may involve only limited processing activities performed manually.

.114 At Jones Grocery, sales are initiated by customers and recorded in the cash register. At the end of the day the
cash register totals are reconciled to the cash on hand, and a deposit is prepared for the day’s receipts. On a weekly basis,
the daily cash register tapes are batched for each store, forwarded to Mrs. Jones, and entered into the computer. The
computer generates a sales register, a sales analysis report, and posts the sales totals to the general ledger. Also, the
processing of inventory transactions (for example, receipt of goods, sales, and spoilage) involves several processing
activities that are linked in the inventory module of the software package. On the other hand, recording depreciation
expense is fairly simple. Fixed assets and the related depreciation are maintained on a computer spreadsheet, and each
month, Mrs. Jones prepares a journal entry to record depreciation.

.115 Understanding the accounting processing also involves understanding the information used for
processing and when processing occurs. For example, when considering the completeness assertion, the
auditor may obtain an understanding about whether transactions entered into the computer system are
processed immediately or in batches and how frequently batches are processed.

.116 The processing of accounting information may involve end user computing. End user computing occurs
when the user is responsible for the development and execution of the computer application that generates
the information used by that same person.

.117 Mrs. Jones developed and maintains the fixed asset spreadsheet that serves as the source document for her
monthly depreciation expense journal entry.

.118 In general, the product of end user computing may be used to

- process significant accounting information outside of the off the shelf accounting software package
  (for example, the fixed-asset spreadsheet is separate from the Jones Grocery general ledger software
  package);
- make significant accounting decisions (for example, a spreadsheet application may be used to
  generate information used to write down inventory); and
- accumulate footnote information (for example, a spreadsheet may be used to calculate the five-year
debt maturity disclosure).

.119 Generally, end users have no training in the formal computer application development process.
Accordingly, applications developed by end users are often inadequately tested, and the development process
is often not documented. This situation can cause significant difficulties for an organization if the end user
computing application is critical to making business or financial decisions.

.120 The access to end user computing applications may also be an audit concern. Many computer
applications used in end user computing come with on-line systems that are capable of restricting users to
specific applications, specific departments, or even specific fields. Often, however, these access restrictions
facilities are not implemented.

.121 To address these concerns and to ensure the end user applications process data completely and
accurately, the auditor may look for control policies and procedures that

- require all significant end user applications to be adequately tested before use;
- prescribe documentation standards for significant end user applications;
- provide for adequate access controls to data;
- provide a mechanism to prevent or detect the use of incorrect versions of data files;
- provide for appropriate applications controls, for example, edit checks, range tests, or reasonableness
  checks; and
support meaningful user reconciliations.

.122 Accounting records, supporting information, and specific accounts. In general, the auditor may identify the following for a client’s significant accounts and transactions:

- Source documents
- Documents converted to computer media
- Computer files that are further processed in the flow of information to the general ledger and the financial statements
- Accounts (subsidiary or general ledger master files) affected by the transaction
- Relevant accounting reports, journals, and ledgers produced in the flow of information to the general ledger and the financial statements

.123 A client’s accounting systems may create many documents, files, and reports that are useful for managing the organization; however, not all will be relevant to the financial statements.

.124 At Jones Grocery, the sales analysis report described in the preceding paragraph .114 is used for management information and analysis. The documents and reports relevant to the financial statements are the daily cash register tapes and the computer generated sales register.

.125 Other significant events and conditions. The entity’s information system may capture other events and conditions that are significant to the financial statements. This might involve, for example, nonrecurring or unusual transactions or adjustments and nonrecurring estimates.

.126 A broken water line, which is an uninsured risk, spoiled a large amount of produce and dry goods in one of the Jones Grocery stores. Based on a list of the lost inventory provided by the store manager, Mrs. Jones recorded a large spoilage loss.

.127 Financial reporting process. When gaining an understanding of the financial reporting process, the auditor may determine the extent of client procedures to prepare accounting estimates (when significant accounting estimates are called for) and information for significant disclosures. The auditor may also understand the way in which general ledger information is summarized to determine how the amounts and disclosures are reported in the financial statements.

Segregation of Duties and Management Override

.128 Small businesses are typically characterized by the following:

- A dominant owner-manager
- A lack of segregation of duties

.129 These characteristics may pose unique risks to the entity.

.130 Duties generally should be divided among different people to reduce the risk of error or inappropriate actions. For instance, responsibilities for authorizing transactions, recording them, and handling the related assets could be divided.

.131 Even small businesses with only a few employees can usually parcel out responsibilities to achieve the necessary checks and balances. If that is not possible—which may be the case on occasion—direct oversight of the incompatible activities by the owner-manager can provide the necessary control. Thus, a dominant owner-manager may be a positive element in the design of internal controls.
A dominant owner-manager may be a negative element in the design of internal control when he or she is able to override established policies and procedures.

Management override is different from management intervention. Management intervention is discussed in the preceding paragraph 35 and is described as the overrule of internal control for legitimate purposes. For example, management intervention is usually necessary to deal with nonrecurring and nonstandard transactions or events that otherwise might be handled by the system.

In contrast, management override is the overrule of internal control for illegitimate purposes with the intent of personal gain or enhanced presentation of an entity’s financial condition or compliance status.

An owner-manager might override the control system for many reasons:
- To increase or decrease reported revenue
- To boost market value of the entity prior to sale
- To meet sales or earnings projections
- To bolster bonus pay-outs tied to performance
- To appear to cover violations of debt covenant agreements
- To hide lack of compliance with legal requirements

Override practices include deliberate misrepresentations to bankers, lawyers, accountants, and vendors, as well as intentionally issuing false documents such as sales invoices.

When gaining an understanding of internal control, the auditor assesses the risk of management override.

Assessing Internal Control Strengths and Weaknesses

When obtaining an understanding of internal control, the auditor may consider the collective effect of strengths and weaknesses in various control environment factors. Management’s strengths and weaknesses may have a pervasive effect on internal control. For example, owner-manager controls may mitigate a lack of segregation of duties. However, human resource policies and practices directed toward hiring competent financial and accounting personnel may not mitigate a strong bias by top management to overstate earnings.

Internal control strengths may indicate account balances, transaction classes, or assertions where you can assess control risk at low or moderate. Internal control weaknesses usually indicate areas where substantive procedures may be required. However, in situations where electronic evidence (information transmitted, processed, maintained, or accessed by electronic means) is significant, testing of the related internal control generally is necessary to obtain sufficient competent audit evidence.

In rare circumstances, the auditor’s understanding of internal control may raise doubts about the auditability of an entity’s financial statements. Concerns about the integrity of the entity’s management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted. Concerns about the nature and extent of an entity’s records may cause the auditor to conclude it is unlikely that sufficient appropriate audit evidence will be available to support an opinion on the financial statements.

If the auditor concludes that it is unlikely that sufficient appropriate audit evidence will be available to support an unqualified opinion on the financial statements, the auditor should consider a qualification or disclaimer of opinion. In some cases, the auditor’s only recourse may be to withdraw from the engagement.

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2 Control risk may be assessed in quantitative terms, such as percentages, or in qualitative terms such as high, medium, or low risk.
Practical Guidance

Readers may refer to appendix M, “Illustrative Audit Documentation Case Study: Young Fashions, Inc.,” of the AICPA Audit Guide Assessing and Responding to Audit Risk in a Financial Statement Audit for examples of how to document your understanding of internal control. Appendix M contains several subappendixes (appendix M-1–M-6). Those that are particularly relevant to internal control include the following:

- Appendix M-2, “Young Fashions: Evaluation of Entity-Level Controls,” provides example documentation of the auditors evaluation of entity-level controls, except for IT general controls. Appendix M-2 illustrates how to document your understanding of the controls relevant to the audit, including (1) an evaluation of whether the design of the control, individually or in combination, is capable of effectively preventing or detecting and correcting material misstatements and (2) a determination of whether the control exists and the entity is using it.

- Appendix M-2-1, “Young Fashions: Procedures Performed to Evaluate Entity-Level Controls,” provides illustrative documentation for the risk assessment and other procedures an auditor performs to gather information about internal control and the source of that information.

- Appendix M-3, “Young Fashions: Understanding of Internal Control—IT General Controls,” provides example documentation of the auditors evaluation of IT general controls.

- Appendix M-4, “Young Fashions: Evaluation of Activity-Level Controls—Wholesale Sales,” provides example documentation of an evaluation of activity-level controls. This case study presents only one class of transactions, sales. In practice, the auditor would evaluate activity-level controls for each significant class of transactions.

[The next page is 5001.]
AAM Section 5000
Designing and Performing Further Audit Procedures

The material included in these sections on designing and performing further audit procedures is presented for illustrative purposes only. The nature, extent, and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the assessed risks of material misstatement.

This manual is a nonauthoritative practice aid. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate. Please also note that this manual does not deal with specialized industry issues; refer to applicable AICPA Audit and Accounting Guides for industry guidance.

TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>5100</td>
<td>01-.42</td>
</tr>
<tr>
<td>Designing Further Audit Procedures</td>
<td>01-.42</td>
</tr>
<tr>
<td>Audit Procedures for Obtaining Audit Evidence</td>
<td>01-.04</td>
</tr>
<tr>
<td>Linking the Assessed Risks to the Design of Further Audit Procedures</td>
<td>05-.06</td>
</tr>
<tr>
<td>Overall Responses to Risks at the Financial Statement Level</td>
<td>07-.13</td>
</tr>
<tr>
<td>Audit Procedures Responsive to Risks of Material Misstatement at the Relevant Assertion Level</td>
<td>14-.19</td>
</tr>
<tr>
<td>Nature of Further Audit Procedures</td>
<td>20-.35</td>
</tr>
<tr>
<td>Inquiry</td>
<td>21-.26</td>
</tr>
<tr>
<td>Substantive Analytical Procedures</td>
<td>27-.32</td>
</tr>
<tr>
<td>The Selection of Audit Procedures</td>
<td>33-.35</td>
</tr>
<tr>
<td>Timing of Further Audit Procedures</td>
<td>36-.38</td>
</tr>
<tr>
<td>Extent of Further Audit Procedures</td>
<td>39-.41</td>
</tr>
<tr>
<td>Documentation</td>
<td>42</td>
</tr>
<tr>
<td>5200</td>
<td>01-.59</td>
</tr>
<tr>
<td>Performing Tests of Controls</td>
<td>01-.59</td>
</tr>
<tr>
<td>General Considerations When Testing Controls</td>
<td>05-.16</td>
</tr>
<tr>
<td>Sources of Audit Evidence About Internal Control Effectiveness</td>
<td>05</td>
</tr>
<tr>
<td>Risk Assessment Procedures vs. Tests of Controls</td>
<td>06-.07</td>
</tr>
<tr>
<td>Evidence of Operating Effectiveness of Controls at a Service Organization</td>
<td>08</td>
</tr>
<tr>
<td>Evaluating the Effectiveness of Complementary Controls</td>
<td>09-.12</td>
</tr>
<tr>
<td>The Relationship Between Tests of Controls and Substantive Tests</td>
<td>13-.14</td>
</tr>
<tr>
<td>A Financial Statement Audit vs. an Examination of Internal Control</td>
<td>15-.16</td>
</tr>
<tr>
<td>Determining the Nature of the Tests of Controls</td>
<td>17-.26</td>
</tr>
<tr>
<td>Tests of IT Controls</td>
<td>22</td>
</tr>
<tr>
<td>Tests of Spreadsheets</td>
<td>23</td>
</tr>
<tr>
<td>Dual Purpose Tests</td>
<td>24-.26</td>
</tr>
<tr>
<td>Determining the Timing of Tests of Controls</td>
<td>27-.43</td>
</tr>
<tr>
<td>Section</td>
<td>Perform Tests of Controls—continued</td>
</tr>
<tr>
<td>-----------</td>
<td>------------------------------------</td>
</tr>
<tr>
<td>5200</td>
<td>Updating Tests of Controls Performed During an Interim Period</td>
</tr>
<tr>
<td></td>
<td>Use of Audit Evidence Obtained in Prior Audits</td>
</tr>
<tr>
<td></td>
<td>Rotating Emphasis on Tests of Controls</td>
</tr>
<tr>
<td></td>
<td>Determining the Extent of Tests of Controls</td>
</tr>
<tr>
<td></td>
<td>Sampling Considerations</td>
</tr>
<tr>
<td></td>
<td>Extent of Testing IT Controls</td>
</tr>
<tr>
<td></td>
<td>Assessing the Operating Effectiveness</td>
</tr>
<tr>
<td></td>
<td>Evidence About Operating Effectiveness</td>
</tr>
<tr>
<td></td>
<td>Investigating Additional Implications of Identified Deviations</td>
</tr>
<tr>
<td></td>
<td>Assessing Effectiveness</td>
</tr>
<tr>
<td></td>
<td>Deficiencies in the Operation of Controls</td>
</tr>
<tr>
<td></td>
<td>Documentation</td>
</tr>
<tr>
<td>5300</td>
<td>Performing Substantive Procedures</td>
</tr>
<tr>
<td></td>
<td>Nature of Substantive Procedures</td>
</tr>
<tr>
<td></td>
<td>Tests of Details</td>
</tr>
<tr>
<td></td>
<td>Substantive Analytical Procedures</td>
</tr>
<tr>
<td></td>
<td>Timing of Substantive Procedures</td>
</tr>
<tr>
<td></td>
<td>Substantive Procedures Performed at an Interim Date</td>
</tr>
<tr>
<td></td>
<td>Substantive Procedures Performed in Previous Audits</td>
</tr>
<tr>
<td></td>
<td>Extent of the Performance of Substantive Procedures</td>
</tr>
<tr>
<td></td>
<td>Adequacy of Presentation and Disclosure</td>
</tr>
<tr>
<td></td>
<td>Documentation</td>
</tr>
<tr>
<td>5400</td>
<td>Audit Sampling Considerations</td>
</tr>
<tr>
<td></td>
<td>Authoritative Standards</td>
</tr>
<tr>
<td></td>
<td>When AU Section 350 Applies</td>
</tr>
<tr>
<td></td>
<td>Authoritative Guidance About the Application of Audit Sampling to Substantive</td>
</tr>
<tr>
<td></td>
<td>Tests Provided by AU Section 350</td>
</tr>
<tr>
<td></td>
<td>Determining Extent of Testing in a Small Business Without Sampling</td>
</tr>
<tr>
<td></td>
<td>Identification of Individual Items to Be Examined</td>
</tr>
<tr>
<td></td>
<td>Is Extent of Audit Evidence Obtained Sufficient?</td>
</tr>
<tr>
<td></td>
<td>Consider Contribution of Other Procedures</td>
</tr>
<tr>
<td></td>
<td>Evaluation of Sufficiency of Evidence</td>
</tr>
<tr>
<td></td>
<td>Audit Sampling for Tests of Controls</td>
</tr>
<tr>
<td></td>
<td>Audit Sampling for Substantive Tests of Details</td>
</tr>
<tr>
<td>5500</td>
<td>Suggested Supplemental Reference Materials</td>
</tr>
<tr>
<td></td>
<td>Suggested Supplemental Reference Materials</td>
</tr>
</tbody>
</table>

[The next page is 5101.]
AAM Section 5100

Designing Further Audit Procedures

Audit Procedures for Obtaining Audit Evidence

.01 In order to draw reasonable conclusions on which to base the audit opinion, auditors should obtain audit evidence by performing audit procedures to

- obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels (audit procedures performed for this purpose are referred to as risk assessment procedures);
- when necessary or when the auditor has determined to do so, test the operating effectiveness of controls in preventing or detecting material misstatements at the relevant assertion level (audit procedures performed for this purpose are referred to as tests of controls); and
- detect material misstatements at the relevant assertion level (audit procedures performed for this purpose are referred to as substantive procedures and include tests of details of classes of transactions, account balances, and disclosures, and substantive analytical procedures).

.02 The auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion and must be supplemented by further audit procedures in the form of tests of controls, when relevant or necessary, and substantive procedures.

.03 Tests of controls are necessary in two circumstances. When the auditor’s risk assessment includes an expectation of the operating effectiveness of controls, the auditor should test those controls to support the risk assessment. In addition, when the substantive procedures alone do not provide sufficient appropriate audit evidence, the auditor should perform tests of controls to obtain audit evidence about their operating effectiveness. See AAM section 5200 for additional guidance on performing tests of controls.

.04 As described in AU section 318, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (AICPA, Professional Standards, vol. 1), the auditor should plan and should perform substantive procedures to be responsive to the related planned level of detection risk, which includes the results of tests of controls, if any. The auditor’s risk assessment is judgmental, however, and may not be sufficiently precise to identify all risks of material misstatement. Further, there are inherent limitations in internal control, including the risk of management override, the possibility of human error, and the effect of systems changes. Therefore, regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure to obtain sufficient appropriate audit evidence. See AAM section 5300 for additional guidance on performing substantive procedures.

Linking the Assessed Risks to the Design of Further Audit Procedures

.05 As discussed in AAM section 3130, the auditor’s risk assessment process culminates with the articulation of the account balances, classes of transactions, or disclosures where material misstatements are most likely to occur and—even more specifically—how the misstatements may occur and the assertions that are likely to be misstated. This assessment of the risks of misstatement, which relates identified financial reporting risks to what can go wrong at the assertion level, provides a basis for the design of further audit procedures.
To reduce audit risk to an acceptably low level, the auditor should determine overall responses to address the assessed risks of material misstatement at the financial statement level and should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. The overall responses and the nature, timing, and extent of the further audit procedures to be performed are matters for the professional judgment of the auditor.

Overall Responses to Risks at the Financial Statement Level

The auditor’s audit response to financial statement level risks should be responsive to the assessed risk. The same is true for responses to risk at the account, assertion level, or both. It is critical that the auditor’s audit procedures are linked clearly and responsive to the assessment. This linkage between risk assessment and audit procedures is part of the audit strategy and audit plan, and it should be documented. The following paragraph describes some important characteristics of financial statement level risks. The purpose of these descriptions is to help the auditor bridge between the assessment of financial statement level risks and the subsequent response.

Characteristics of financial statement level risks that are relevant for audit purposes include the following:

- **Financial statement level risks can affect many assertions.** By definition, financial statement level risks may result in material misstatements of several accounts or assertions. For example, a lack of controls over journal entries increases the risk that an inappropriate journal entry could be posted to the general ledger as part of the period-end financial reporting process. The posting of an inappropriate journal entry may not be isolated to one general ledger account but potentially could affect any account. In general, overall audit risk increases when the magnitude or scope of an identified risk of misstatement is not known.

- **Assessing financial statement-level risks requires significant judgment.** Ultimately, the auditor relates identified risks of misstatement to what can go wrong. For example, suppose that while performing risk assessment procedures to gather information about the control environment, the auditor discovered weaknesses relating to the hiring, training, and supervision of entity personnel. These weaknesses result in an increased risk of a misstatement of the financial statements, but it will be a matter of the auditor’s professional judgment to determine the following:
  - The accounts and relevant assertions that could be affected
  - The likelihood that a financial statement misstatement will result from the increased risk
  - The significance of any misstatement

- **Risks at the Financial Statement Level May Not be Identifiable With Specific Assertions.** Control weaknesses at the financial statement level can render well-designed activity-level controls ineffective. For example, a significant risk of management override can potentially negate existing controls and procedures at the activity level in many accounts and for many assertions. Linking such a risk to specific accounts and assertions may be very difficult and may not even be possible. As another example, a client may have excellent data input controls at the application level. But if poorly designed IT general controls allow many unauthorized personnel the opportunity to access and inappropriately change the data, the well-designed input controls have been rendered ineffective. Also, strengths in financial statement-level controls such as an overall culture of ethical behavior may increase the reliability of controls that operate at the activity level. Determining the extent to which financial statement level controls affect the reliability of specific activity level controls (and, therefore, the assessment of the risks of material misstatement) is subjective and may vary from client to client.

Due to the unique characteristics of financial statement level risks, it may not be possible to correlate all of these risks to a finite set of assertions. For example, a weakness in control environment may affect all or mostly all of the accounts, classes of transactions, or disclosures and the relevant assertions. To respond
appropriately to these types of financial statement level risks, the auditor may need to reconsider the overall approach to the engagement. The following paragraph provides examples of overall responses to risks at the financial statement level that have a pervasive effect on the financial statements and cannot necessarily be mapped to individual assertions.

.10 The auditor’s overall responses to address the assessed risks of material misstatement at the financial statement level may include the following:

- Emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence.
- Assigning more experienced staff or those with specialized skills or using specialists.
- Providing more supervision.
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed and in selecting individual items for testing.
- Making general changes to the nature, timing, or extent of further audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date. One could also focus more time and attention on audit areas more closely associated with the risk.

.11 The assessment of the risks of material misstatement at the financial statement level is affected by the auditor’s understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to perform some audit procedures at an interim date rather than at period end. If there are weaknesses in the control environment, the auditor should consider an appropriate response. For example, the auditor could perform audit procedures as of the period end rather than at an interim date, seek more extensive audit evidence from substantive procedures, modify the nature of audit procedures to obtain more persuasive audit evidence, or increase the number of locations to be included in the audit scope.

.12 Such considerations, therefore, have a significant bearing on the auditor’s general approach, for example, an emphasis on substantive procedures (substantive approach) or an approach that uses tests of controls as well as substantive procedures (combined approach).

.13 Paragraphs .13 and .50 of AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), describe the overall responses the auditor may take in response to your assessment of the risk of material misstatement due to fraud. When determining an overall audit response, the auditor may consider the assessment of fraud risk concurrently with the assessment of the risk of material misstatement due to error. The auditor can develop one overall response that is appropriate for both kinds of risks.

**Audit Procedures Responsive to Risks of Material Misstatement at the Relevant Assertion Level**

.14 Further audit procedures provide important audit evidence to support the auditor’s audit opinion. These procedures consist of tests of controls and substantive tests.

.15 The auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor’s further audit procedures and the risk assessments.

.16 In designing further audit procedures, the auditor should consider such matters as the following:
The significance of the risk and the likelihood that a material misstatement will occur. In general, the more significant (in terms of likelihood and magnitude) the risk, the more reliable and relevant audit evidence should be.

The characteristics of the class of transactions, account balance, or disclosure involved, which will help determine the nature, timing, and extent of procedures available to the auditor. For example, the gross accounts receivable balance comprises transactions with third parties, which means the auditor can contact these external parties to confirm the transactions or individual account balances. On the other hand, the allowance for doubtful accounts is an estimate prepared internally, which does not lend itself to confirmation but to other substantive tests.

The nature of the specific controls used by the entity, in particular, whether they are manual or automated.

Whether the auditor expects to obtain audit evidence to determine if the entity’s controls are effective in preventing or detecting material misstatements.

The nature of the audit procedures is of most importance in responding to the assessed risks.

.17 The auditor’s assessment of the identified risks at the relevant assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. In some cases, the auditor may determine that performing only substantive procedures is appropriate for specific relevant assertions and risks. In those circumstances, the auditor may exclude the effect of controls from the relevant risk assessment. This may be because the auditor’s risk assessment procedures have not identified any effective controls relevant to the assertion or because testing the operating effectiveness of controls would be inefficient. However, the auditor needs to be satisfied that performing only substantive procedures for the relevant assertions would be effective in reducing detection risk to an acceptably low level. The auditor often will determine that a combined audit approach using both tests of the operating effectiveness of controls and substantive procedures is an effective audit approach.

.18 Regardless of the audit approach selected, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. Because effective internal controls generally reduce, but do not eliminate, risk of material misstatement, tests of controls reduce, but do not eliminate, the need for substantive procedures. In addition, analytical procedures alone may not be sufficient in some cases. For example, when auditing certain estimation processes such as examining the allowance for doubtful accounts, the auditor may perform substantive procedures beyond analytical procedures (for example, examining cash collections subsequent to period end) due to the risk of management override of controls or the subjectivity of the account balance.

.19 In the case of very small entities, there may not be many control activities that could be identified by the auditor. For this reason, the auditor’s further audit procedures are likely to be primarily substantive procedures. In such cases, in addition to the matters referred to in the preceding paragraph .16, the auditor should consider whether in the absence of controls it is possible to obtain sufficient appropriate audit evidence.

Nature of Further Audit Procedures

.20 The nature of further audit procedures refers to the following:

- Their purpose, that is, tests of controls or substantive procedures (or dual purpose tests) and whether they are designed to test for overstatement, understatement, or both

- Their type, such as the following:
  - Inspection
  - Observation
  - Inquiry
— Confirmation
— Recalculation
— Reperformance
— Analytical procedures (including scanning)

Table 1 provides additional guidance on each of these procedures.

<table>
<thead>
<tr>
<th>Type of Procedure</th>
<th>Definition</th>
<th>Additional Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inspection of documents</td>
<td>Inspection of documents involves examining records or documents, whether</td>
<td>• This procedure provides audit evidence of varying degrees of reliabil-</td>
</tr>
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<td></td>
<td>internal or external, in paper form, electronic form, or other media.</td>
<td>ity, depending on their nature and source and, in the case of internal</td>
</tr>
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<td>• Some documents represent direct audit evidence of the existence of an</td>
</tr>
<tr>
<td>Inspection of tangible</td>
<td>Inspection of tangible assets consists of physical examination of the</td>
<td>• Inspecting an executed contract may provide audit evidence relevant to</td>
</tr>
<tr>
<td>assets</td>
<td>assets.</td>
<td>• Some forms of documents are less persuasive than others. For example,</td>
</tr>
<tr>
<td></td>
<td></td>
<td>faxes and copies may be less reliable than original documents.</td>
</tr>
<tr>
<td>Observation</td>
<td>Observation consists of looking at a process or procedure being performed</td>
<td>• This procedure may provide audit evidence relating to existence, but</td>
</tr>
<tr>
<td></td>
<td>by others.</td>
<td>not necessarily about the entity’s rights and obligations or the valuation</td>
</tr>
<tr>
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<td></td>
<td>of the assets.</td>
</tr>
<tr>
<td></td>
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<td>• Inspection of individual inventory items ordinarily accompanies the</td>
</tr>
<tr>
<td></td>
<td></td>
<td>observation of inventory counting.</td>
</tr>
</tbody>
</table>

(continued)
<table>
<thead>
<tr>
<th>Type of Procedure</th>
<th>Definition</th>
<th>Additional Guidance</th>
</tr>
</thead>
</table>
| Confirmation      | Confirmation is the process of obtaining a representation of information or of an existing condition directly from a knowledgeable third party. | • This procedure  
  — frequently is used in relation to account balances and their components but need not be restricted to these items;  
  — can be designed to ask if any modifications have been made to an agreement, and if so, what the relevant details are; and  
  — also is used to obtain audit evidence about the absence of certain conditions (for example, the absence of an undisclosed agreement that may influence revenue recognition).  
| Recalculation     | Recalculation consists of checking the mathematical accuracy of documents or records. | • This procedure can be performed through the use of information technology, for example, by applying a data extraction application or other computer assisted audit techniques (CAATs). |
| Reperformance     | Reperformance is the auditors independent execution of procedures or controls that were originally performed as part of the entity’s internal control | • This procedure may be performed either manually or through the use of CAATs, for example, reperforming the aging of accounts receivable. |

### Inquiry

.21 Inquiry consists of seeking information of knowledgeable individuals. These individuals may be involved in the financial reporting process or outside of that process; they may be internal or external to the company. Inquiry is used extensively throughout the audit and often is complementary to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Asking questions of knowledgeable individuals is only part of the inquiry process. Evaluating the responses to inquiries is an equally integral part of the process.

.22 Inquiry normally involves such actions as the following:

- Considering the knowledge, objectivity, experience, responsibility, and qualifications of the individual to be questioned
- Asking clear, concise, and relevant questions
- Using open or closed questions appropriately
- Listening actively and effectively
- Considering the reactions and responses and asking follow-up questions
- Evaluating the response

.23 Responses to inquiries may provide the auditor with information he or she did not previously possess or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information the auditor has obtained, such as information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures. The auditor should resolve any significant inconsistencies in the information obtained.

.24 The auditor should perform audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Inquiry alone ordinarily does not provide sufficient appropriate audit evidence to detect a material misstatement. Moreover, inquiry alone is not sufficient to test the operating effectiveness of controls.

.25 In some instances, the auditor may need to obtain evidence about management’s intended actions, for example, when obtaining evidence to support management’s classification of investments as either trading, available for sale, or held to maturity. To corroborate management’s responses to questions regarding their intended future action, the following may provide relevant information:

- Management’s past history of carrying out its stated intentions
- Management’s stated reasons for choosing a particular course of action
- Management’s ability to pursue a specific course of action

.26 In some cases, the auditor should obtain replies to inquiries in the form of written representations from management. For example, when obtaining oral responses to inquiries, the nature of the response may be so significant that it warrants obtaining written representation from the source. See AU section 333, Management Representations (AICPA, Professional Standards, vol. 1), for further guidance on written representations.

Substantive Analytical Procedures

.27 Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts. Analytical procedures are used for the following purposes:

a. To assist the auditor in planning the nature, timing, and extent of other auditing procedures
b. As risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control
c. As a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions
d. As an overall review of the financial information in the final review stage of the audit

.28 Analytical procedures can be effective:

- For certain types of assertions (for example, the completeness assertion, which cannot be tested directly using a test of balances on recorded amounts)
- When the relationships between amounts are very predictable
- When the data used to develop expectations based on the relationship are reliable
- When relatively precise expectations can be developed
Analytical procedures can provide evidence supporting financial statement assertions and, thus, can be used as substantive tests. Because analytical procedures are often the least expensive tests, they may be used whenever practical.

Paragraph .05 of AU section 329, Analytical Procedures (AICPA, Professional Standards, vol. 1), describes analytical procedures as follows:

Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor’s understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:

a. Financial information for comparable prior period(s) giving consideration to known changes
b. Anticipated results—for example, budgets, or forecasts including extrapolations from interim or annual data
c. Relationships among elements of financial information within the period
d. Information regarding the industry in which the client operates—for example, gross margin information
e. Relationships of the financial information with relevant nonfinancial information

Whenever analytical procedures are applied as substantive tests, the auditor may apply the following procedures:

- Consider whether the relationship is plausible and predictable.
- Consider whether the data used for the comparison is reliable.
- Consider whether the account balance tested is consistent with the auditor’s expectations. If it is not consistent, obtain the client’s explanation for the variance and get evidence to corroborate the client’s explanation.

AU section 329 states that analytical procedures should be performed in the planning and overall review stages of all audits. See AU section 329 and AAM section 3155 for further guidance on analytical procedures.

The Selection of Audit Procedures

The auditor’s selection of audit procedures is based on the risk of material misstatement. The higher the auditor’s assessment of risk, the more reliable and relevant the audit evidence sought by the auditor from substantive procedures is. This determination of the requisite reliability and relevance of audit evidence may affect both the types of audit procedures to be performed and their combination. For example, the auditor may confirm the completeness of the terms of a contract with a third party, in addition to inspecting the document and obtaining management’s representation. This combination of several procedures would result in more reliable and relevant audit evidence than obtained by performing only one procedure.

In determining the audit procedures to be performed, the auditor should consider the underlying reasons for the assessment of the risk of material misstatement at the relevant assertion level for each class of transactions, account balance, and disclosure. These underlying reasons relate to both the inherent and control risks related to the assertion. For example, if the auditor assessed risk of material misstatement to be low that a material misstatement might occur because of low inherent risk, the auditor may determine that substantive analytical procedures alone may provide sufficient appropriate audit evidence. On the other hand, if the auditor expects that there is a lower risk of material misstatement because the client has effective controls and the auditor intends to design substantive procedures based on relying on the effective operation of those
controls, then the auditor should perform tests of controls to obtain audit evidence about their operating effectiveness.

.35 The auditor should obtain audit evidence about the accuracy and completeness of information produced by the entity’s information system when that information is used in performing audit procedures. For example, if the auditor uses nonfinancial information or budget data produced by the entity’s information system in performing audit procedures, such as substantive analytical procedures or tests of controls, the auditor should obtain audit evidence about the accuracy and completeness of such information.

Timing of Further Audit Procedures

.36 Timing refers to when audit procedures are performed or the period or date to which the audit evidence applies. The auditor may perform tests of controls or substantive procedures:

- At an interim date
- At period end
- After period end, in those instances where the procedure cannot be performed prior to or at year end (for example, agreeing the financial statements to the accounting records)

.37 The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to or at the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). On the other hand, performing audit procedures before the period end may assist the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters. If the auditor performs tests of the operating effectiveness of controls or substantive procedures before period end, the auditor should consider the additional evidence that is necessary for the remaining period.

.38 In considering when to perform audit procedures, the auditor should also consider such matters as the following:

- The assessed risk of misstatement. In general, the higher the risk, the more likely it is that the auditor will perform procedures nearer to or at the period end.
- The control environment. In general, the more effective the control environment, the more likely it is that the auditor will be able to perform tests as of an interim date.
- When relevant information is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times).
- The nature of the risk (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the auditor may examine contracts available on the date of the period end).
- The period or date to which the audit evidence relates.

Extent of Further Audit Procedures

.39 Extent refers to the quantity of a specific audit procedure to be performed, for example, a sample size or the number of observations of a control activity. The extent of an audit procedure is determined by the judgment of the auditor after considering the following:

- Tolerable misstatement
- Assessed risk of material misstatement
- Degree of assurance the auditor plans to obtain
In particular, the auditor may increase the extent of audit procedures as the risk of material misstatement increases. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk and reliable; therefore, the nature of the audit procedure is the most important consideration.

The AICPA Audit Guide *Audit Sampling* provides additional guidance on sampling for substantive testing.

**Documentation**

The auditor should document the overall responses to address the assessed risks of misstatement at the financial statement level and the linkage of those procedures with the assessed risks at the relevant assertion level. The manner in which these matters are documented is based on the auditor’s professional judgment. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.

[The next page is 5201.]
AAM Section 5200

Performing Tests of Controls

.01 The auditor should perform tests of controls when the auditor’s risk assessment\(^1\) includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level.

.02 When, in accordance with paragraph .117 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), the auditor has determined that it is not possible or practicable to reduce the detection risks at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures, he or she should perform tests of controls to obtain audit evidence about their operating effectiveness. For example, as discussed in paragraphs .119–.120 of AU section 314, the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the relevant assertion level when an entity conducts its business using information technology (IT) and no documentation of transactions is produced or maintained, other than through the IT system.

.03 Tests of the operating effectiveness of controls are performed only on those controls that the auditor has determined are suitably designed to prevent or detect a material misstatement in a relevant assertion. Paragraphs .106–.108 of AU section 314 discuss the identification of controls at the relevant assertion level likely to prevent or detect a material misstatement in a class of transactions, account balance, or disclosure.

.04 Testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented. When obtaining audit evidence of implementation by performing risk assessment procedures, the auditor should determine that the relevant controls exist and that the entity is using them. When performing tests of controls, the auditor should obtain audit evidence that controls operate effectively. This includes obtaining audit evidence about

- how controls were applied at relevant times during the period under audit,
- the consistency with which they were applied, and
- by whom or by what means they were applied.

If substantially different controls were used at different times during the period under audit, the auditor should consider each separately. The auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.

General Considerations When Testing Controls

Sources of Audit Evidence About Internal Control Effectiveness

.05 The audit evidence used to provide support for the auditor’s conclusion about the operating effectiveness of controls during the audit period may come from a variety of sources, including the following:

- Tests of controls performed during the current period.
- Risk assessment procedures performed during the current period.
- Evidence provided in a type 2 SAS No. 70 report (see AU section 324, *Service Organizations* [AICPA, *Professional Standards*, vol. 1]).
- Evidence obtained from the performance of procedures in previous audits.

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\(^1\) The auditor’s strategy reflects the level of assurance the auditor plans to obtain regarding controls.
The information gathered and conclusions reached as part of the auditor’s quality control procedures for client acceptance and continuance. For example, client acceptance procedures may include inquiries of attorneys, bankers, or others in the business community about client management that provide insight into their competence, integrity, operating philosophy, and ethical values.

Risk Assessment Procedures vs. Tests of Controls

.06 Risk assessment procedures allow the auditor to evaluate the design effectiveness of internal controls for the purpose of assessing risks of material misstatement. Tests of controls build on the auditor’s evaluation of design effectiveness and allow the auditor to assess the operating effectiveness of controls during the operating period. The results of the auditor tests of controls are used to design substantive procedures.

.07 Although some risk assessment procedures that the auditor performs to evaluate the design of controls and to determine that they have been implemented may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, a walkthrough or the observation of the performance of a control may provide evidence about the operating effectiveness of controls. In such circumstances, the auditor should consider whether the audit evidence provided by those audit procedures is sufficient.

Evidence of Operating Effectiveness of Controls at a Service Organization

.08 A Type 2 service auditor’s report may provide evidence about the operating effectiveness of controls at a service organization. However, controls over the information provided to the service organization may still need to be assessed.

Evaluating the Effectiveness of Complementary Controls

.09 When designing tests of controls, typically the auditor will focus first on testing control activities, because the control activities component of internal control is the one most directly related to the assertion. For example, physically counting goods that have been received and comparing the quantity and description to the vendor’s packing slip is directly related to both the existence and valuation of inventory.

.10 However, in addition to testing the controls that relate directly to the assertion, the auditor should consider the need to obtain audit evidence supporting the effective operation of the complementary controls upon which the effectiveness of the direct control depends.

.11 When considering the need to test complementary controls, the auditor may consider the following:

• The significance of the complementary control to the effective functioning of the direct control. As the effectiveness of the direct control becomes more dependent on the complementary control, the auditor’s need to test the indirect control increases.

• The relative significance of the audit evidence of the complementary control to the auditor’s conclusion on the effectiveness of the direct control. The auditor’s conclusion about the operating effectiveness of a control activity is supported by a combination of evidence about (i) the operating effectiveness of the direct control activity itself and (ii) the operating effectiveness of other, complementary controls upon which the effectiveness of the direct control depends. In some instances, the auditor may be
able to support a conclusion based primarily on tests of the direct control, with little evidence about the operating effectiveness of the related complementary controls. In other instances (for example, IT application controls), the auditor’s conclusion may be based primarily on tests of the complementary controls and little on tests of the direct control. In those situations where you rely significantly on the operating effectiveness of the complementary control, the auditor might obtain more sufficient and adequate audit evidence to support the conclusion on the operating effectiveness of the indirect control, for example, the monitoring of the performance of the reconciliation.

- The degree of reliability required of the audit evidence obtained about internal control operating effectiveness. Testing the complementary control increases the reliability of the audit evidence obtained about the operating effectiveness of the direct control. For example, the auditor may test four month-end reconciliations and draw a conclusion about the effectiveness of those reconciliations for an entire 12-month period. If the auditor has tested the operating effectiveness of the complementary controls related to the reconciliation, the conclusion about the effectiveness of the reconciliation during the period the auditor did not test will be more reliable than if the auditor did not test the complementary controls.

- Evidence of operating effectiveness that may have been obtained as part of obtaining an understanding of the design and implementation of the complementary controls. When performing risk assessment procedures to obtain an understanding of internal control, the auditor may obtain some information about the operating effectiveness of the complementary controls that are indirectly related to an assertion. For example, risk assessment procedures may provide the auditor with some evidence about the operating effectiveness of portions of the control environment. This information about operating effectiveness may be limited, but nevertheless, it may be sufficient for the purpose of drawing a conclusion about the operating effectiveness of the direct control.

.12 When testing complementary controls, the auditor may choose not to test the operating effectiveness of the entire component to which the complementary control pertains, but may limit the tests to those elements of the component that have an immediate bearing on the effectiveness of the direct control. For example, when testing controls over purchasing to place moderate reliance on them, the auditor may consider the need to test the control environment or IT general controls relating to the entire entity beyond the design and implementation assessment procedures the auditor already has performed. If practical, the auditor may limit the tests to those aspects of the control environment or IT general controls that have a direct bearing on the financial statement assertions related to purchasing. To place high reliance on the controls, the auditor may often need to gather additional evidence concerning the IT general controls and overall control environment to support high reliance on the purchasing controls.

The Relationship Between Tests of Controls and Substantive Tests

.13 There is an inverse relationship between the audit evidence to be obtained from substantive tests and that obtained from tests of controls. As the sufficiency and adequacy of the audit evidence obtained from tests of controls increases, the sufficiency and adequacy of the audit evidence required from substantive tests generally decreases. For example, in circumstances when the auditor adopts an approach consisting primarily of tests of controls, in particular related to those risks where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures, the auditor should perform tests of controls to obtain a high level of assurance about their operating effectiveness.

.14 On the other hand, the more audit evidence from substantive tests, the less audit evidence from tests of controls would be necessary. In many instances, the nature and extent of substantive tests alone may provide sufficient, adequate evidence at the assertion level, which would make the testing of control effectiveness (beyond assessing the design and implementation of the related controls) unnecessary.

A Financial Statement Audit vs. an Examination of Internal Control

.15 Testing the operating effectiveness of internal control to support an opinion on the financial statements is different from testing controls to support an opinion on the effectiveness of the internal control system.
In an attestation engagement to examine the effectiveness of internal control, the audit evidence obtained from the tests of internal control is the only evidence the auditor has to support an opinion. In contrast, when performing an audit of the financial statements, the auditor ordinarily performs both tests of controls and substantive tests. The objective of the tests of controls in a financial statement audit is to assess the operating effectiveness of controls and incorporate this assessment into the design of the nature, timing, and extent of substantive procedures. Thus, when testing controls in a financial statement audit, the auditor has flexibility in determining not only whether to test controls, and if so which controls to test, but also the level of effectiveness of those controls that is necessary to provide the desired level of support for an opinion on the financial statements.

Determining the Nature of the Tests of Controls

The nature of the procedures the auditor performs to test controls has a direct bearing on the relevance and reliability of audit evidence. When responding to assessed risks of material misstatement, the nature of the audit procedures is of most importance. Performing more tests or conducting the tests closer to the period end will not compensate for a poorly designed test that lacks sufficient relevance or reliability in gathering audit evidence about the effectiveness of a control.

The types of audit procedures available for obtaining audit evidence about the effectiveness of controls includes the following:

- Inquiries of appropriate entity personnel
- Inspection of documents, reports, or electronic files indicating performance of the control
- Observation of the application of the control
- Reperformance of the application of the control by the auditor

The nature of the particular control influences the type of audit procedure necessary to obtain audit evidence about operating effectiveness. Documentation may provide evidence about the performance of some controls; in these situations, the auditor may inspect this documentation to obtain evidence about the operating effectiveness of the control.

For other controls, complete documentation may not be available or relevant. For example, documentation of the operation may be sketchy for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as control activities performed automatically by the client’s IT system. In these circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation of the performance of the control or the use of computer assisted audit techniques (CAATs). Entities can be encouraged to improve weak documentation.

Because of the limits of inquiry and observation, inquiry combined with inspection or reperformance ordinarily provide more reliable audit evidence than a combination of only inquiry and observation. For example, the auditor may inquire about and observe the entity’s procedures for opening the mail and processing cash receipts to test the operating effectiveness of controls over cash receipts. Because an observation is pertinent only at the point in time at which it is made, the auditor may supplement the observation with other observations or inquiries of entity personnel, and the auditor may also inspect documentation about the operation of such controls at other times during the audit period.

Tests of IT Controls

Because of the inherent consistency of IT processing, audit evidence about the implementation of an automated control, combined with audit evidence about the operating effectiveness of IT general controls (and in particular, security and change controls) may provide substantial audit evidence about the operating effectiveness of the control during the entire audit period. That is, once the auditor has determined that an IT application control has been implemented (placed in operation), the auditor may draw a conclusion about
the operating effectiveness of the IT portion of the control activity, so long as the auditor has determined that relevant IT general controls are operating effectively.

Tests of Spreadsheets

.23 The development and use of spreadsheets typically lack the controls that usually are present for formal, purchased software. Absent audit evidence indicating that appropriate general controls over spreadsheets have been implemented, the auditor might continue to test spreadsheet controls even after their implementation.

Dual Purpose Tests

.24 Some audit procedures may simultaneously provide audit evidence that both

- support the relevant assertion or detects material misstatement and
- support a conclusion about the operating effectiveness of related controls.

Tests that achieve both of these objectives concurrently on the same transaction typically are referred to as dual purpose tests. For example, the auditor may examine an invoice to determine whether it has been approved and also to provide substantive audit evidence about the existence and amount of the transaction.

.25 When performing a dual purpose test, the auditor should carefully consider whether the design and evaluation of such tests can accomplish both objectives. For example, the population of controls and the population of substantive procedures should be the same. If tests on components of a balance such as receivables are designed as dual purpose tests, only evidence of the controls operating over period-end balance items will be obtained.

.26 Furthermore, when performing such tests, the auditor should consider how the outcome of the tests of controls may affect the auditor’s determination about the extent of substantive procedures to be performed. For example, if controls are found to be ineffective, the auditor should consider whether the sample size for substantive procedures should be increased from that originally planned.

Determining the Timing of Tests of Controls

.27 The timing of tests of controls affects the relevance and reliability of the resulting audit evidence. In general, the relevance and reliability of the audit evidence obtained diminishes as time passes between the testing of the controls and the end of the period under audit. For this reason, when tests of controls are performed during an interim period or carried forward from a previous audit, the auditor should determine what additional audit evidence should be obtained to support a conclusion on the current operating effectiveness of those controls.

.28 The timing of tests of controls depends on the auditor’s objective:

a. When controls are tested as of a point in time, the auditor may obtain audit evidence that the controls operated effectively only at that time.

b. When controls are tested throughout a period, the auditor may obtain audit evidence of the effectiveness of the operation of the control during that period.

.29 Audit evidence pertaining only to a point in time may be sufficient for the auditor’s purpose, for example, when testing controls over the client’s physical inventory counting at the period end. If, on the other hand, the auditor needs audit evidence of the effectiveness of a control over a period, audit evidence pertaining only to a point in time may be insufficient, and the auditor should supplement those tests with others that provide audit evidence that the control operated effectively during the period under audit. For example, for an automated control, the auditor may test the operation of the control at a particular point in time. The auditor then may perform tests of controls to determine whether the control operated consistently
during the audit period, or the auditor may test with the intention of relying on general controls pertaining to the modification and use of that computer program during the audit period.

.30 The tests the auditor performs to supplement tests of controls at a point of time may be part of the tests of controls over the client’s monitoring of controls.

Updating Tests of Controls Performed During an Interim Period

.31 The auditor may test controls as of or for a period that ends prior to the balance sheet date. This date often is referred to as the interim date or interim period. The period of time between the interim date or period and the balance sheet date often is referred to as the remaining period.

.32 When the auditor tests controls during an interim period or as of an interim date, the auditor should:

• obtain audit evidence about the nature and extent of any significant changes in internal control that occurred during the remaining period and
• determine what additional audit evidence should be obtained for the remaining period.

.33 To determine what additional audit evidence the auditor should obtain to update tests of controls performed in advance of the balance sheet date, the auditor should consider the following:

• The significance of the assessed risks of material misstatement at the relevant assertion level
• The specific controls that were tested during the interim period
• The degree to which audit evidence about the operating effectiveness of those controls was obtained
• The length of the remaining period
• The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls
• The control environment
• The volume or value of transactions processed in the remaining period

.34 When testing controls as of or during an interim period, the auditor may obtain additional audit evidence about the operating effectiveness of controls during the remaining period by performing procedures such as

• extending the testing of the operating effectiveness of controls over the remaining period or
• testing the client’s monitoring of controls.

.35 For example, the auditor might perform

• inquiries and observations related to the performance of the control, the monitoring of the control, or any changes to the control during the remaining period;
• a walkthrough covering the period between the interim date and the period end; and
• the same procedures performed at interim, but directed to the period from interim to period end.

Use of Audit Evidence Obtained in Prior Audits

.36 If certain conditions are met, the auditor may use audit evidence obtained in prior audits to support the conclusion about the operating effectiveness of controls in the current audit. If the auditor plans to use evidence obtained in prior periods, the auditor should consider

• whether the use of this evidence is appropriate and
• the length of the time period that may elapse before retesting the control.
.37 The following table summarizes the factors the auditor should consider when determining whether to use audit evidence about the operating effectiveness obtained in a prior audit.

<table>
<thead>
<tr>
<th>Appropriateness of Using Evidence From Prior Audit</th>
<th>Length of Time Before Retesting Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>May be appropriate</td>
<td>May not be appropriate</td>
</tr>
<tr>
<td>Length of Time Before Retesting Control</td>
<td>Length of Time Before Retesting Control</td>
</tr>
<tr>
<td>Effective design and operation</td>
<td>Evidence of poor design or operation</td>
</tr>
<tr>
<td>Largely automated control</td>
<td>Largely automated control</td>
</tr>
<tr>
<td>Minor changes in client circumstances, including personnel</td>
<td>Significant changes in client circumstances, including personnel</td>
</tr>
<tr>
<td>Control operated effectively in prior audit</td>
<td>Control did not operate effectively in prior audit</td>
</tr>
<tr>
<td>Low risk of material misstatement for relevant assertion</td>
<td>High risk of material misstatement for relevant assertion</td>
</tr>
<tr>
<td>Low reliance on the control</td>
<td>High reliance on the control</td>
</tr>
</tbody>
</table>

.38 If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in prior audits, the auditor should

- obtain audit evidence about whether changes in those specific controls have occurred subsequent to the prior audit and
- perform audit procedures to establish the continuing relevance of audit evidence obtained in the prior audit.

.39 Even when the auditor uses audit evidence about the operating effectiveness of controls obtained in prior periods, the auditor still should evaluate the design effectiveness and implementation of controls in the current period. The procedures performed as described in the preceding paragraph may help the auditor fulfill this responsibility; however, the auditor may have to supplement these procedures with others. For example, if the controls have not changed from the previous period but the client’s business process has, the auditor will need to determine whether the design of controls remains effective in light of the changed business processes.

.40 The auditor may not rely on audit evidence about the operating effectiveness of controls obtained in prior audits for controls that

- have changed significantly since the prior audit,
• pertain to business processes that have changed significantly since the prior audit, and
• mitigate significant risks.

For any control that meets one of the preceding criteria, the auditor should test operating effectiveness in the current audit.

41 For example, changes in a system that enable an entity to receive a new report from the system probably is not a significant change and, therefore, is unlikely to affect the relevance of prior period audit evidence. On the other hand, a change that causes data to be accumulated or calculated differently probably is significant and, therefore, does affect the relevance of audit evidence obtained in the prior period, in which case the operating effectiveness of the control should be tested in the current period.

Rotating Emphasis on Tests of Controls

42 When the auditor plans to rely on controls that have not changed since they were last tested, the auditor should test the operating effectiveness of these controls at least once in every third year in an annual audit. There also may be some controls, such as over revenue recognition or inventories that, due to their importance to the client financial statements, might be subject to testing every two years or every year, depending on the risks, even when there are purported to be no changes in controls.

43 When there are a number of controls for which the auditor plans to use audit evidence obtained in prior audits, the auditor should test the operating effectiveness of some controls each audit. However, when the auditor is testing controls for only one or two key classes of transactions in an entity, rotating the testing of these controls may not be warranted.

Determining the Extent of Tests of Controls

44 The extent of the auditor’s tests of controls affects the sufficiency of the audit evidence obtained to support the auditor’s assessment of the operating effectiveness of controls. To reduce the extent of substantive procedures in an audit, the tests of controls performed by the auditor need to be sufficient to determine the operating effectiveness of the controls
• at the relevant assertion level and
• either throughout the period, or as of the point in time when the auditor plans to rely on the control.

45 Factors the auditor may consider in determining the extent of tests of controls include the following:
• The frequency of the performance of the control by the entity during the period.
• The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
• The relevance and reliability of the audit evidence to be obtained in supporting that the control prevents, or detects and corrects, material misstatements at the relevant assertion level.
• The extent to which audit evidence is obtained from tests of other controls that meet the same audit objective.
• The extent to which the auditor plans to rely on the operating effectiveness of the control in the assessment of risk (and thereby reduce substantive procedures based on the reliance of such control). The more the auditor relies on the operating effectiveness of controls in the assessment of risk, the greater is the extent of the auditor’s tests of controls.
• The expected deviation from the control.
Sampling Considerations

.46 The auditor should consider using an audit sampling technique to determine the extent of tests whenever the control is applied on a transaction basis (for example, matching approved purchase orders to supplier invoices) and that it is applied frequently. When a control is applied periodically (for example, monthly reconciliations of accounts receivable subsidiary ledger to the general ledger), the auditor should consider guidance appropriate for testing smaller populations (for example, testing the control application for two months and reviewing evidence the control operated in other months or reviewing other months for unusual items). AU section 350, Audit Sampling (AICPA, Professional Standards, vol. 1), and the AICPA Audit Guide Audit Sampling provide further guidance on the application of sampling techniques to determine the extent of testing of controls. The AICPA Audit Guide Audit Sampling also provides guidance for testing in smaller populations.

.47 The auditor should consider the expected deviation from the control when determining the extent of tests. As the rate of expected deviation from a control increases, the auditor should increase the extent of testing of the control. However, if the rate of expected deviation is expected to be too high, the auditor may determine that tests of controls for a particular assertion may not be effective. In this case, the auditor may conclude that a control deficiency exists and the auditor should consider its severity and whether it should be communicated to those charged with governance, management, or both.

Extent of Testing IT Controls

.48 Generally, IT processing is inherently consistent. An automated control should function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Therefore, the auditor may be able to limit the testing of an IT application control to one or a few instances of the control operation, provided that the auditor determines that related IT general controls operated effectively during the period of reliance.

Assessing the Operating Effectiveness of Controls

Evidence About Operating Effectiveness

.49 The concept of effectiveness of the operation of controls recognizes that some deviations in the way a client applies the controls may occur. Deviations from prescribed controls may be caused by factors such as changes in key personnel, significant seasonal fluctuations in volume of transactions, and human error.

.50 When the auditor encounters deviations in the operation of controls, those deviations will have an effect on the auditor’s assessment of operating effectiveness. A control with an observed non-negligible deviation rate is not an effective control. For example, if a test is designed in which the auditor selects a sample of, say, 25 items and expects no deviations, the finding of one deviation would be considered a non-negligible deviation because, based on the results of the test of the sample, the desired level of confidence has not been obtained.

.51 There are sources of audit evidence beyond the auditor’s tests of controls that contribute to the auditor’s assessment of the operating effectiveness of controls. The extent of misstatements detected by performing substantive procedures also may alter the auditor’s judgment about the effectiveness of controls in a negative direction. However, misstatement-free results of substantive tests do not indicate that a lower assessment of control risk may be substituted for the one supported by the procedures the auditor used to assess control risk.

Investigating Additional Implications of Identified Deviations

.52 When the auditor detects control deviations during the performance of tests of controls, the auditor should make specific inquiries to understand these matters and their potential consequences, for example, by inquiring about the timing of personnel changes in key internal control functions.
Deviations in the application of control activities may be caused by the ineffective operation of indirect controls such as IT general controls, the control environment, or other components of internal control. To gain an understanding of the deviations in control, the auditor may wish to make inquiries and perform other tests to identify possible weaknesses in the control environment or other indirect controls.

For example, suppose that one of the client’s primary controls related to the existence of inventory—periodic test counts—had several instances where the number of items counted by the count teams did not agree to the actual physical count of the items on hand. When gaining a further understanding of the nature of these deviations, the auditor determines that the underlying cause is poor training of the test count teams and a lack of written instructions. Training and written instructions are indirect controls that may affect the operating effectiveness of controls other than those related to existence. For example, the lack of training and instruction could result in the count teams reporting the wrong product number or description, which also could affect the valuation of inventory. This finding could cause the company and auditor to conclude that a recount is necessary once the teams are properly trained.

Assessing Effectiveness

After considering the results of tests of controls and any misstatements detected from the performance of substantive procedures, the auditor should determine whether the audit evidence obtained provides an appropriate basis for reliance on the controls. If the reliance on the controls is not warranted, the auditor should determine whether

- additional tests of controls are necessary or
- if the potential risks of misstatement will be addressed using substantive procedures.

Once the auditor has concluded that reliance on certain controls is not warranted, it is unnecessary to perform further tests of those controls.

Deficiencies in the Operation of Controls

The auditor may consider whether deviations in the operation of controls have been caused by an underlying control deficiency. When evaluating the reason for a control deviation, the auditor may consider the following:

- Whether the control is automated (in the presence of effective information technology general controls, an automated application control is expected to perform as designed)
- The degree of intervention by entity personnel contributing to the deviation (for example, was the deviation evidence of a possible override)
- Management’s actions in response to the matter (if management was aware of the deviation)

Regardless of the reason for the deviation, numerous or repeated instances of the deviation may constitute a significant deficiency or material weakness. The following are examples of circumstances that may be control deficiencies of some magnitude:

- Failure in the operation of properly designed controls within a significant account or process, for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process.
- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy (for example, the failure to obtain timely and accurate consolidating information from remote locations that is needed to prepare the financial statements).
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. For example, a company uses security devices to safeguard its inventory (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its financial reporting. However, a preventive control failure may be mitigated by an effective detective control that prevents...
the misstatement of the financial statements. Suppose the inventory security control fails. Although
the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material
misstatement to the financial statements if performed effectively and timely (near or at the reporting
date). In the absence of a timely count, a deficient preventive control may be a deficiency in internal
controls of some magnitude.

- Failure to perform reconciliations of significant accounts, for example, accounts receivable subsidiary
  ledgers are not reconciled to the general ledger account in a timely or accurate manner.

- Undue bias or lack of objectivity by those responsible for accounting decisions, for example,
  consistent under accruals of expenses or overstatement of allowances at the direction of management.

- Misrepresentation by client personnel to the auditor (an indicator of fraud).

- Management override of controls that would enable the entity to prepare financial statements in
  accordance with generally accepted accounting principles.

- Failure of an application control caused by a deficiency in the design or operation of an IT general
  control.

.58 The following diagram summarizes the auditor’s considerations related to tests of controls.
In regards to the performance of further audit procedures, the auditor should document the following:

- The overall responses to address the assessed risks of misstatement at the financial statement level
- The nature, timing, and extent of the further audit procedures
- The linkage of those procedures with the assessed risks at the relevant assertion level
- The results of the audit procedures
- The conclusions reached with regard to the use in the current audit of audit evidence about the operating effectiveness of controls that was obtained in a prior audit

The manner in which these matters are documented is based on the auditor’s professional judgment. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.

[The next page is 5301.]
AAM Section 5300

Performing Substantive Procedures

.01 The objective of substantive procedures is to detect individual misstatements that alone or in the aggregate cause material misstatements at the assertion level. Substantive procedures include the following:

- Tests of details of transactions, account balances, and disclosures.
- Analytical procedures. AU section 329, Analytical Procedures (AICPA, Professional Standards, vol. 1), establishes standards and provides guidance on the application of analytical procedures as substantive tests.

.02 The auditor should plan and perform substantive procedures to be responsive to the related assessed risks of material misstatement. However, the auditor should perform certain tests regardless of the risk assessment because the risk assessment may not identify all risks.

- Substantive tests of material items. The auditor should perform substantive procedures for all relevant assertions for each material class of transactions, account balance, and disclosure. For example, if the auditor determines that long term debt is a material account, the auditor should perform substantive tests for all assertions that are relevant to long term debt, even if the auditor has determined that it is unlikely that the assertion could contain a material misstatement. The auditor may determine that the risk of the entity not having the obligation to repay the debt (the obligation assertion) is low, but nevertheless, the auditor should perform a substantive procedure (for example, confirming the terms of the debt with the lender) to address the risk. Because the account is material, the auditor is precluded from relying solely on risk assessment procedures or tests of controls to support the conclusion.

- Substantive tests related to the financial statement reporting system. On all engagements the auditor should
  — agree the financial statements, including their accompanying notes, to the underlying accounting records and
  — examine material journal entries and other adjustments made during the course of preparing the financial statements. The nature and extent of the auditor’s examination of journal entries and other adjustments depend on the nature and complexity of the client’s financial reporting system and the associated risks of material misstatement.

.03 When, in accordance with paragraph .110 of AU section 314, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (AICPA, Professional Standards, vol. 1), the auditor has determined that an assessed risk of material misstatement at the relevant assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk. When the audit approach to significant risks consists only of substantive procedures, the audit procedures appropriate to address such significant risks consist of

- tests of details only.
- a combination of tests of details and analytical procedures.

That is, to address significant risks, it is unlikely that audit evidence obtained solely from substantive analytical procedures will be sufficient.
Nature of Substantive Procedures

.04 Substantive procedures include tests of details and substantive analytical procedures. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Tests of details are ordinarily more appropriate to obtain audit evidence regarding certain relevant assertions about account balances, including existence and valuation.

.05 The auditor should plan substantive procedures to be responsive to the planned level of detection risk. In some situations, the auditor may determine that performing only substantive analytical procedures may be sufficient to reduce the planned level of detection risk to an acceptably low level. For example, the auditor may determine that performing only substantive analytical procedures is responsive to the planned level of detection risk for an individual class of transactions where the auditor’s assessment of risk has been reduced by obtaining audit evidence from performance of tests of the operating effectiveness of controls. In other situations, the auditor may determine that tests of details only are appropriate, or that a combination of substantive analytical procedures and tests of details is most responsive to the assessed risks. The auditor’s determination as to the substantive procedures that are most responsive to the planned level of detection risk is affected by whether the auditor has obtained audit evidence about the operating effectiveness of controls.

Tests of Details

.06 The auditor should design tests of details responsive to the assessed risk with the objective of obtaining sufficient appropriate audit evidence to achieve the planned level of assurance at the relevant assertion level. In designing substantive procedures related to the existence or occurrence assertion, the auditor should select from items contained in a financial statement amount and should obtain the relevant audit evidence. On the other hand, in designing audit procedures related to the completeness assertion, the auditor should select from audit evidence indicating that an item should be included in the relevant financial statement amount and should investigate whether that item is so included. The knowledge gained when understanding the business and its environment should be helpful in selecting the nature, timing, and extent of audit procedures related to the completeness assertion. For example, the auditor might inspect subsequent cash disbursements and compare them with the recorded accounts payable to determine whether any purchases had been omitted from accounts payable.

Substantive Analytical Procedures

.07 In designing substantive analytical procedures, the auditor should consider such matters as the following:

- The suitability of using substantive analytical procedures, given the assertions. Analytical procedures may not be suitable for all assertions. For example, transactions subject to management discretion (such as a decision to delay advertising expenses) may lack the predictability between periods or financial statement accounts that is necessary to perform and effective analytical procedure.

- The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed. To assess the reliability of the data used in a substantive analytical procedure, the auditor may consider its source and the conditions under which it was gathered.

- Whether the expectation is sufficiently precise to identify the possibility of a material misstatement at the desired level of assurance. The precision of the auditor’s expectation depends on (among other things)
  - the identification and consideration of factors that significantly affect the amount being audited (for example, contributions to an employee 401(k) plan depends on compensation expense and the percentage of the employer contribution committed to by management).
  - the level of data used to develop the expectation. Typically, expectations developed at a detailed level have a greater chance of detecting a material misstatement than do broad comparisons.
The amount of any difference in recorded amounts from expected values that is acceptable. The smaller the difference between the expected amount and the recorded amount that can be accepted, the more precise the expectation will typically be.

The risk of management override of controls. Management override of controls might result in adjustments to the financial statements outside of the normal financial reporting process, which may result in artificial changes to the financial statement relationships being analyzed. These artificial relationships may result in the auditor drawing erroneous conclusions about the substantive analytical procedures.

Paragraphs .57–.67 of AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), direct the auditor to perform certain procedures to assess the risk of management override of controls.

.08 Paragraphs .09–.21 of AU section 329 establishes standards and provides additional guidance on the design of substantive analytical procedures.

Timing of Substantive Procedures
Substantive Procedures Performed at an Interim Date

.09 In some circumstances, the auditor may choose to perform substantive procedures at an interim date. When the auditor performs procedures as of a date in advance of year end, the risk that the auditor will fail to detect a material misstatement that may exist at year end is increased. This risk increases as the length of the period between interim tests and year end increases. The following table summarizes factors that may be considered when determining whether to perform substantive procedures at an interim date.

Matters to Consider in Determining Whether to Perform Substantive Procedures at an Interim Date

<table>
<thead>
<tr>
<th>Factor to consider</th>
<th>More likely</th>
<th>Less likely</th>
</tr>
</thead>
<tbody>
<tr>
<td>Control environment and other relevant controls</td>
<td>Effectively designed or operating controls, including the control environment</td>
<td>Ineffectively designed or operating controls, including the control environment</td>
</tr>
<tr>
<td>The availability of information for the remaining period</td>
<td>Information is available that will allow the auditor to perform procedures related to the remaining period</td>
<td>Lack of information necessary to perform procedures related to the remaining period</td>
</tr>
<tr>
<td>Assessed risk</td>
<td>Lower risk of material misstatement for the relevant assertion</td>
<td>Higher risk of material misstatement for the relevant assertion</td>
</tr>
<tr>
<td>Nature of transactions or account balances and relevant assertions</td>
<td>Year-end balances are reasonably predictable with respect to amount, relative significance, and composition</td>
<td>Year-end balances can fluctuate significantly from interim balances, for example, due to rapidly changing business conditions, seasonality of business, or transactions that are subject to management’s discretion</td>
</tr>
<tr>
<td>Ability to perform audit procedures to cover remaining period</td>
<td>The auditor will be able to perform all necessary procedures to cover the remaining period</td>
<td>The auditor’s ability to perform procedures relating to the remaining period is limited, for example, by a lack of available information</td>
</tr>
</tbody>
</table>
The objective of some of the tests may make the results of the tests irrelevant if performed at an interim date. For example, tests related to the preparation of the financial statements or the client’s compliance with debt covenants typically provide relevant audit evidence only if performed at the period end.

In addition to those items described in the preceding table, the circumstances of the engagement may result in the performance of certain tests at an interim date. For example, a client may request that the auditor identify all material misstatements a short period of time after year end (which is common for companies that wish to issue a press release of their earnings for the period). In that situation, the auditor may decide to confirm receivables prior to year end because the time period between the end of the period and the release of earnings is too short to allow the auditor to send and receive confirmations of customers and to complete the test work.

The auditor’s ability to perform audit procedures relating to the remaining period depends a great deal on whether the client’s accounting system is able to provide the information needed for the auditor to perform his or her procedures. The auditor should consider whether that information is sufficient to permit investigation of the following:

- Significant unusual transactions or entries (including those at or near the period end)
- Other causes of significant fluctuations or fluctuations that did not occur
- Changes in the composition of the classes of transactions or account balances

The timing of audit procedures also involves consideration of whether related audit procedures are coordinated properly. This consideration includes, for example, the following:

- Coordinating the audit procedures applied to related party transactions and balances
- Coordinating the testing of interrelated accounts and accounting cutoffs
- Maintaining temporary audit control over assets that are readily negotiable and simultaneously testing such assets and cash on hand and in banks, bank loans, and other related items

When performing substantive procedures at an interim date, the auditor should perform substantive procedures or substantive procedures combined with tests of controls to cover the remaining period that provide a reasonable basis for extending audit conclusions from the interim date to the period end.

When performing substantive procedures at an interim date, the auditor may reconcile the account balance at the interim date to the balance in the same account at year end. The reconciliation will allow the auditor to

- identify amounts that appear unusual,
- investigate these amounts, and
- define the appropriate population to perform substantive analytical procedures or tests of details to test the remaining period.

If misstatements are detected in classes of transactions or account balances at an interim date, the auditor should consider modifying the related assessment of risk and the planned nature, timing, or extent of the substantive procedures covering the remaining period that relate to such classes of transactions or account balances, or the auditor may extend or may repeat such audit procedures at the period end.

Substantive Procedures Performed in Previous Audits

In most cases, audit evidence from substantive procedures performed in a prior audit provides little or no audit evidence for the current period. To use audit evidence obtained during a prior period in the current period audit, both the audit evidence and the related subject matter must not fundamentally change. For example, a legal opinion would continue to be relevant audit evidence if it were received in a prior period related to the structure of a securitization transaction and no changes have occurred during the current period.
If the auditor plans to use audit evidence from a prior period in the current audit, the auditor should perform audit procedures during the current period to establish the continuing relevance of the audit evidence.

**Extent of the Performance of Substantive Procedures**

.18 The greater the risk of material misstatement, the greater the extent of the auditor’s substantive procedures. However, the nature of the audit procedures is of most importance in responding to assessed risks. Increasing the extent of an audit procedure is appropriate only if the procedure itself is relevant to the specified risk.

.19 *Considerations for designing tests of details.* When determining the extent of the tests of details, the auditor ordinarily thinks in terms of sample size. However, the auditor also may consider other matters, including whether it is more effective to use other selective means of testing, such as selecting large or unusual items from a population, rather than performing sampling or stratifying the population into homogeneous sub-populations for sampling. AU section 350, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1), and the AICPA Audit Guide *Audit Sampling*, provide guidance on the use of sampling and other means of selecting items for testing.

**Adequacy of Presentation and Disclosure**

.20 The auditor should perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, are in accordance with generally accepted accounting principles (GAAP). The auditor should consider whether the individual financial statements are presented in a manner that reflects the appropriate classification and description of financial information. The presentation of financial statements in conformity with GAAP also includes adequate disclosure of material matters. These matters relate to the form, arrangement, and content of the financial statements and their related notes, including, for example, the terminology used, the amount of detail given, the classification of items in the financial statements, and the bases of amounts set forth. The auditor should consider whether management should have disclosed a particular matter in light of the circumstances and facts of which the auditor is aware at the time. In performing the evaluation of the overall presentation of the financial statements, including the related disclosures, the auditor should consider the assessed risk of material misstatement at the relevant assertion level. See paragraph .15 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), for a description of the relevant assertions related to presentation and disclosure.

**Documentation**

.21 In regards to the performance of further audit procedures, the auditor should document the following:

- The overall responses to address the assessed risks of misstatement at the financial statement level
- The nature, timing, and extent of the further audit procedures
- The linkage of those procedures with the assessed risks at the relevant assertion level
- The results of the audit procedures
- The conclusions reached with regard to the use in the current audit of audit evidence about the operating effectiveness of controls that was obtained in a prior audit

The manner in which these matters are documented is based on the auditor’s professional judgment. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.

[The next page is 5401.]
AAM Section 5400

Audit Sampling Considerations

.01 Once an auditor decides what audit procedures to apply (the nature of the tests) and when to apply them (the timing of the tests), the next decision to be made is to determine how many items to apply which procedures to—that is, the extent of testing. The greater the risk of material misstatement, the less detection risk that can be accepted, and, consequently, the greater the extent of substantive procedures. Because the risks of material misstatement include consideration of the effectiveness of internal control, the extent of substantive procedures may be reduced by satisfactory results from tests of the operating effectiveness of controls. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

.02 In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size, which is affected by the planned level of detection risk, tolerable misstatement, expected misstatement, and nature of the population. However, the auditor should also consider other matters, including whether it is more effective to use other selective means of testing, such as selecting large or unusual items from a population as opposed to performing sampling or stratifying the population into homogeneous subpopulations for sampling.

Authoritative Standards

.03 AU section 350, Audit Sampling (AICPA, Professional Standards, vol. 1), addresses a variety of issues relating to the auditor’s use of sampling in an audit engagement. However, AU section 350 does not always apply when the auditor is examining less than 100 percent of a population. The AICPA Audit Guide Audit Sampling presents recommendations on the application of generally accepted auditing standards to audits involving the use of audit sampling methods, and provides guidance to help auditors apply audit sampling in accordance with AU section 350.

When AU section 350 Applies

.04 Audit sampling is only one of many tools used by auditors to obtain sufficient, appropriate audit evidence to support an opinion on financial statements. AU section 350 discusses design, selection, and evaluation considerations to be applied by the auditor when using audit sampling. As a general rule, audit sampling can be used

• in tests of controls in internal control to evaluate operating effectiveness from prescribed controls,
• in substantive tests of details of account balances and classes of transactions, and
• in dual purpose tests that assess control risk and test whether the monetary amount of a transaction is correct.

.05 The portion of AU section 350 pertaining to tests of controls applies when sampling techniques are used to assess control risk. The portion pertaining to substantive tests apply when sampling techniques are used to test details of transactions or balances.

.06 According to AU section 350, sampling occurs when the auditor tests less than 100 percent of a population for the purpose of evaluating some characteristic of an account balance or class of transactions. AU section 350 applies to tests of controls when such tests are performed and to tests of balances when sampling populations are material. The extent to which sampling is used in an audit depends on the size of the client and the nature of the client’s internal control. Also, if the sampling populations are small, it could be more efficient to audit individually significant items and obtain audit assurance about the remaining
balance through analytical procedures than to perform audit sampling. As the size and sophistication of the client’s internal control increases, the auditor is more likely to use audit sampling to perform tests of controls and tests of balances.

.07 In determining whether AU section 350 is applicable to circumstances in which an auditor examines less than 100 percent of the items making up an account balance or class of transactions, the auditor should consider the purpose of the test. AU section 350 establishes standards and provides guidance when the auditor intends to project the test results to the entire account balance or class of transactions for the purpose of evaluating a characteristic of the balance or class. For example, if the auditor intends to examine selected sales invoices to draw a conclusion about whether sales are overstated, audit sampling as described in AU section 350 is applied because the auditor intends to draw a conclusion about all sales. On the other hand, if the auditor selects several large sales invoices for certain audit tests and then applies analytical procedures to assess the accuracy and valuation of the remaining invoices, the auditor is not sampling according to AU section 350—the examination of the large items is not intended to lead the auditor to a conclusion about the other items. In that case, any conclusion about whether sales are overstated is based on the results of the test of large sales invoices, inquiry and observations, analytical procedures, and other auditing procedures performed on the smaller items related to overstatement of sales. However, in practice, it is difficult to attain high assurance regarding a significant aggregate amount of smaller items in the population from procedures other than sampling, such as analytical tests.

.08 The way in which the population is defined can determine whether the requirements of AU section 350 apply. The auditor might choose to divide a single reporting line on the financial statements into several populations. For example, accounts receivable might be divided into wholesale receivables, retail receivables, and employee receivables. Each of these populations can be tested using a different audit strategy—some using audit sampling and others not. The sampling concepts in AU section 350 apply only to populations for which audit sampling is used. Use of audit sampling on one population does not mandate its use on remaining populations.

Authoritative Guidance About the Application of Audit Sampling to Substantive Tests Provided by AU Section 350

.09 AU section 350 contains the following provisions regarding sampling in connection with substantive testing:

- The concept that some items exist for which, in the auditor’s judgment, acceptance of some sampling risk is not justified, and that these should be examined 100 percent (see paragraph .21 of AU section 350). This simply reminds the auditor that some of the items encountered in an examination of financial statements may be so significant individually or may have such a high likelihood of being in error or misstated that all such items should be examined.

- The suggestion that the efficiency of a sample may be improved by separating items subject to sampling into relatively homogeneous groups based on some characteristic (see paragraph .22 of AU section 350). This indicates that audit efficiency can sometimes be improved by, for example, stratifying or segregating the items constituting a balance or class of transactions into groups based on individual dollar value or some other characteristic.

- Paragraph .18 of AU section 350 establishes a requirement that the auditor considers tolerable misstatement in planning audit sampling applications in the examination of account balances and classes of transactions. The auditor should consider, in the early stages of an audit, how much misstatement the auditor will be able to tolerate for each balance and class of transactions that is sampled, in combination with misstatements in other accounts, and still render an unqualified opinion on the financial statements. According to AU section 350, the auditor should consider tolerable misstatement and to recognize that it is one of the factors influencing sample size.

- Paragraph .24 of AU section 350 establishes a requirement that the auditor selects a sample that can be expected to be representative of the population. Simply put, this means that each item in the population being sampled should have a chance of being selected, not necessarily an equal chance of
being selected. This does not mean that the auditor should use a random or probability sample, but that he or she should use a method that avoids bias (for example, selecting only simple transactions for testing).

- Paragraph .25 of AU section 350 establishes a requirement that the auditor considers selected sample items to which the auditor is unable to apply planned audit procedures to determine their effect on the evaluation of the sample. For example, sometimes the auditor may not be able to apply planned audit procedures to selected sample items because the entity may not be able to locate supporting documentation. If the auditor’s evaluation of the sample results would not be altered by considering those unexamined items to be misstated, it is not necessary to examine the items. However, if considering those unexamined items to be misstated would lead to a conclusion that the balance or class contains material misstatement, the auditor should consider alternative audit procedures that would provide sufficient appropriate audit evidence to form a conclusion.

- Paragraph .26 of AU section 350 establishes a requirement that the auditor projects the misstatement results of the sample to the items from which the sample was selected. Because the sample is expected to be representative of the population from which it was selected, misstatements found are also expected to be representative of the population. The auditor should measure the likely misstatement in the population from which the sample was drawn and to consider it in reaching his or her conclusions.

- Paragraph .30 of AU section 350 establishes a requirement that the auditor considers, in the aggregate, projected misstatement results for all audit sampling applications and all known misstatements from nonsampling applications, along with other relevant audit evidence, when evaluating whether the financial statements taken as a whole may be materially misstated.

Documentation Requirements

.10 AU section 350 contains no specific documentation requirements. However, the documentation standards set forth in the Statements on Auditing Standards dealing with documentation apply to audit sampling applications just as they apply to other auditing procedures. AU section 311, Planning and Supervision (AICPA, Professional Standards, vol. 1), states that the auditor “must develop an audit plan in which the auditor documents the audit procedures,” and AU section 339, Audit Documentation (AICPA, Professional Standards, vol. 1), states that audit documentation of tests of operating effectiveness of controls and substantive tests of details that involve inspection of documents or confirmation should include an identification of the items tested. The identification of the items tested may be satisfied by indicating the source from which the items were selected and the specific selection criteria, for example:

- when a haphazard or random sample is selected, the documentation should include identifying characteristics (for example, the specific invoice numbers of the items included in the sample);

- when all items over a specified dollar amount are selected from a listing, the documentation need describe only the scope and the identification of the listing (for example, all invoices over $25,000 from the December sales journal); and

- when a systematic sample is selected from a population of documents, the documentation need only provide an identification of the source of the documents and an indication of the starting point and the sampling interval (for example, a systematic sample of shipping reports was selected from the shipping log for the period from X to Y, starting with report number 14564 and selecting every 250th report from that point).

With regard to audit sampling applications, the audit program might document such items as the objectives of the sampling application and the audit procedures related to those objectives. Examples of items that the auditor may document for tests of controls are discussed in paragraph .25 of this section. Examples of items that the auditor typically documents for substantive tests are discussed in paragraph .55 of this section.
Determining Extent of Testing in a Small Business Without Sampling

.11 Small businesses have certain characteristics that may influence the auditor’s decision to use audit sampling.

.12 For substantive testing, small businesses frequently have small populations of accounting data in both account balances and classes of transactions. Consequently, sampling may not be necessary when the necessary audit assurance is attained by examining a significant portion or aggregate value of all the transactions.

.13 Paragraph .01 of AU section 350 defines audit sampling as “the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.” This definition allows some alternative approaches to sampling to determine the extent of testing in a small business engagement. These alternatives, by not using audit sampling and thus eliminating the requirements of AU section 350, may provide a more effective and efficient audit approach for a small business engagement.

.14 These alternative approaches include the following:
   • Procedures applied to 100 percent of a certain group (strata) of transactions or balances
   • Testing unusual items without applying procedures to the remainder of the population
   • Other tests that involve application of procedures to less than 100 percent of the items in the population without drawing a conclusion about the entire account or class of transactions

.15 The auditor should decide what audit procedures to perform to meet the established audit objectives. Once this decision is made, the auditor needs to determine the extent of testing.

.16 An effective and efficient approach to determining the extent of testing in a small business engagement is shown in flowchart 1. This approach involves four important steps.

Identification of Individual Items to Be Examined

.17 The auditor is required to apply professional judgment in determining which individual items in an account balance or class of transactions need to be examined. In evaluating individual items, the auditor should consider factors such as the size of the item, whether the item is unusual, prior experience with the client, and whether the item involves a related party.

.18 For example, consider the following information for accounts receivable of a small business.

<table>
<thead>
<tr>
<th>Number of Accounts</th>
<th>Balances</th>
<th>Total Accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>$100,000 or more</td>
<td>$625,000</td>
</tr>
<tr>
<td>7</td>
<td>$25,000–99,999</td>
<td>375,000</td>
</tr>
<tr>
<td>62</td>
<td>$1–24,999</td>
<td>300,000</td>
</tr>
<tr>
<td>73</td>
<td>$1,300,000</td>
<td></td>
</tr>
</tbody>
</table>

In this case, if the eleven largest accounts are confirmed by the auditor, most of the accounts receivable balance is supported ($1,000,000 out of $1,300,000, or 77 percent). Provided the remaining $300,000 is not greater than tolerable misstatement or can be tested through other audit procedures, it may not be necessary to design a sample of the remaining items. Also, the auditor may decide to confirm the receivables that have unusual characteristics (for example, receivables with either large credit balances or those that are very delinquent).
Flowchart 1
An Audit Sampling Approach for a Small Business

Step

1. Given the audit objective, determine the specific audit procedures to be performed.

2. Identify individual items to be examined.
   
   Is extent of audit evidence obtained from examining individual items sufficient?
   
   Yes
   
   2. Consider the contribution of other procedures.
      
   No
      
   3. Accept evidence as sufficient.
      
   Is evidence sufficient?
      
   Yes
      
   4. Apply sampling.
Is Extent of Audit Evidence Obtained Sufficient?

.19 The following are some factors in evaluating the sufficiency of audit evidence obtained in tests of details for a particular account balance or class of transactions:

- The individual importance of the items examined. If the items examined, account for a high percentage of the total population, then the auditor may be reasonably assured that there is an acceptably low risk of an undetected misstatement.
- The nature and cause of misstatements. If during the course of the audit, misstatements are discovered, those misstatements should be evaluated to determine if they are due to differences in principle or in application, are errors or fraud or are due to misunderstanding of instructions or carelessness.
- Possible relationship of the misstatement to other phases of the audit. If it is determined that the misstatement is due to fraud, this would ordinarily require a broader consideration of the possible implications than would the discovery of an error.
- The characteristics of the sample to the population. The auditor may obtain some knowledge of the types of items in the population if the characteristics in the sample are similar in nature and the same controls are followed for processing the transactions.

Consider Contribution of Other Procedures

.20 The auditor may also consider whether other evidence obtained contributes to conclusions regarding the account balance or class of transactions. The auditor often considers the contribution of other procedures at the same time the extent of audit evidence obtained from examining individual items is considered.

.21 The auditor may use a combination of analytical procedures and substantive tests of details to support an opinion on the financial statements. In deciding whether other audit procedures make a contribution, the auditor may consider whether they support the audit objectives in the area, whether they indicate potential problems, and whether the evidence is consistent with the previous evidence obtained.

.22 In considering the contribution of other procedures, the auditor should use professional judgment in determining whether an unqualified opinion can be given without performing additional tests in the form of audit sampling.

Evaluation of Sufficiency of Evidence

.23 There are four factors that the auditor may consider in evaluating the sufficiency of audit evidence obtained from examining individual items and contributed by other procedures, and in determining whether the remaining items in the population should be tested.

.24 First, the auditor should consider whether the dollar amount of the remaining population is equal to or greater than an amount that would individually or in combination with other untested amounts be material to the financial statements. If the remaining population is less than material, the auditor may decide that no additional sampling is necessary, but may consider whether other procedures can provide sufficient assurance that any misstatement of the remaining population is not significant. Second, the auditor should consider the degree of risk involved (that is, how susceptible the account is to misstatement, and whether there have been problems with this area in prior audits). Third, the auditor should consider the sufficiency of all the audit evidence obtained so far (the extent of audit evidence obtained by testing individual items along with the contribution of other procedures). The final factor is the qualitative aspects of the misstatement. These include (a) the nature and cause of misstatements, such as whether there are differences in principle or in application, are errors or are caused by fraud, or are due to misunderstanding of instructions or to carelessness, and (b) the possible relationship of the misstatements to other phases of the audit. The discovery of fraud ordinarily requires a broader consideration of possible implications than does the discovery of an error.
Audit Sampling for Tests of Controls

25 AU section 350 indicates that an auditor may use nonstatistical or statistical sampling in performing tests of controls. This section provides guidance for both approaches. Regardless of whether nonstatistical or statistical sampling is being used, audit sampling for tests of controls involves the following steps:

- **Determine the objective of the test.** The objective of tests of controls is to provide evidence about the operating effectiveness of controls. Audit sampling for tests of controls is generally appropriate when application of the control leaves documentary evidence of performance. Normally, audit sampling for tests of controls will involve selecting a sample of documents and examining them for evidence that the relevant controls were applied. Tests of controls involving observation of performance of procedures or inquiries of the client are not normally subject to audit sampling. As with any test, it should be related to a relevant assertion.

- **Define the deviation conditions.** A deviation condition is a situation that indicates that the controls were not performed. For example, if the auditor is examining purchase invoices for evidence of approval of an expenditure (for example, the initials of the approving individual), a deviation condition would be an invoice that is not initialed by the appropriate individual. Performance of a control consists of all the steps the auditor believes are necessary to support the assessed level of control risk. For example, assume that a prescribed control requires that support for every disbursement should include an invoice, a voucher, a receiving report, and a purchase order, all stamped “Paid.” The auditor believes that the existence of an invoice and a receiving report, both stamped “Paid,” is necessary to indicate adequate performance of the control for purposes of supporting the assessed level of control risk. Therefore, a deviation may be defined as “a disbursement not supported by an invoice and a receiving report that have been stamped ‘Paid.’”

- **Define the population.** The population selected should be appropriate for the objective being tested. For example, if the auditor is testing the operating effectiveness of a prescribed control designed to ensure that all shipments were billed, the auditor would not detect deviations by sampling from billed items. An appropriate population for detecting such deviations usually includes the record of all items shipped.

- **Defining the period covered by the test.** For samples to be representative of the period under audit, the population generally includes all transactions processed during the period. Often, auditors perform tests of controls during interim work. The auditor should determine what additional evidence needs to be obtained for the remaining period. Often, the auditor obtains the additional evidence by extending the test to the transactions occurring in the remaining period. However, it is not always efficient to include all transactions executed throughout the period under audit in the population to be sampled. In some cases, it might be more efficient to use alternative approaches to test the performance of the control during the remaining period. In these cases the auditor would define the population to include transactions for the period from the beginning of the year to an interim date and consider the following factors in determining what, if any, additional evidence needs to be obtained for the remaining period:

  - The significance of the assertion involved
  - The specific controls that were tested during the interim period
  - Any changes in controls from the interim period
  - The extent to which substantive tests were changed as a result of the controls
  - The results of the tests of controls performed during the interim period
  - The length of the remaining period
  - The audit evidence about design or operation of controls or substantive correctness of the balances or transactions in the interim period that may result from the substantive tests performed in the remaining period
  - The relevance and effectiveness of information technology general controls
The auditor selects sampling units from a physical representation of the population. For example, if the auditor defines the population as all customer receivable balances as of a specific date, the physical representation might be a printout of the customer accounts receivable trial balance as of that date. Making selections from a controlled source minimizes differences between the physical representation and the population. The auditor should consider whether the physical representation includes the entire population. If the auditor reconciles the selected physical representation and the population and determines that the physical representation has omitted items in the population that should be included in the overall evaluation, the auditor should select a new physical representation or perform alternative procedures on the items excluded from the physical representation.

- **Defining the sampling unit.** The sampling unit is defined in light of the control being tested. A sampling unit may be, for example, a document, an entry, or a line item, where examination of the sampling unit provides evidence of the operation of the control. An important efficiency consideration in selecting a sampling unit is the manner in which documents are filed and cross-referenced.

- **Determine the method of selecting the sample.** Any sample that is selected should be representative of the population (selected in an unbiased manner) and all items should have an opportunity to be selected. Random number selection is generally used when statistical sampling is being applied. When nonstatistical sampling is applied, random number sampling, systematic sampling, haphazard sampling, and block sampling are methods that might be used to obtain a representative sample. Methods of selecting samples are discussed beginning at paragraph .60 of this section.

- **Determine the sample size.** Sample sizes for tests of controls are affected by (a) the risk of assessing control risk too low, (b) the tolerable rate, (c) the expected population deviation rate, and (d) any effects of small population sizes.

- Guidance for determining sample size when performing nonstatistical sampling begins with paragraph .28 of this section. A description of statistical sampling begins with paragraph .31 of this section.

- **Perform the sampling plan.** Once the sample has been selected, the auditor should examine the selected items to determine whether they contain deviations from the prescribed control. If the auditor selects a voided item, and the auditor obtains reasonable assurance that the item has been properly voided and does not represent a deviation from the prescribed control, he or she should replace the voided item. If the auditor selects an unused item, he or she should obtain reasonable assurance that it actually represents an unused item, not a deviation from the control, and then replace the unused item. If the auditor is unable to examine a selected item because it cannot be located or for any other reason, and the auditor is unable to apply the planned audit procedures or appropriate alternative procedures to selected items, he or she should consider the selected items to be deviations from the controls for purposes of evaluating the sample. In addition, the auditor should consider the reasons for this limitation and the effect that such a limitation might have on his or her understanding of internal control and assessment of control risk.

- **Evaluate the sample results.** Guidance for evaluating nonstatistical sampling results begins with paragraph .30 of this section and guidance for evaluating statistical sampling results begins with paragraph .32 of this section.

- **Document the sampling procedure.** Examples of items that the auditor typically documents for tests of controls include the following:
  - A description of the control being tested. The control objectives related to the sampling application, including the relevant assertions
  - The definition of the population (the source from which the items were selected) and the sampling unit, including how the auditor considered the completeness of the population
  - The definition of the deviation condition
Factors Affecting Sample Sizes for Tests of Controls. Sample sizes for tests of controls are affected by the following factors:

- **Acceptable risk of assessing control risk too low.** The risk of assessing control risk too low is the risk that the assessed level of control risk based on the sample is less than the true operating effectiveness of the control. Decreasing the risk of assessing control risk too low will increase the sample size.

- **Expected population deviation rate.** The expected population deviation rate is an anticipation of the deviation rate in the entire population. As the expected population deviation rate increases, the sample size will increase.

- **Tolerable rate.** Tolerable rate is the maximum rate (percentage) of deviation from a prescribed control that the auditor is willing to accept without altering the planned assessed level of control risk. Higher tolerable rates will permit smaller sample sizes.

- **Population size.** The size of the population has little or no effect on the determination of sample size except for very small populations. For example, it is generally appropriate to treat any population of more than 2,000 sampling units as if it were infinite. If the population size is under 2,000 sampling units, the population size may have a small effect on the calculation of the sample size.

The effects of these factors on the appropriate nonstatistical sample size may be summarized as follows:

<table>
<thead>
<tr>
<th>Factor</th>
<th>General Effect on Sample Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk of assessing control risk too low—</td>
<td></td>
</tr>
<tr>
<td>increase (decrease)</td>
<td>Smaller (larger)</td>
</tr>
<tr>
<td>Tolerable rate—increase (decrease)</td>
<td>Smaller (larger)</td>
</tr>
<tr>
<td>Expected population deviation rate—</td>
<td></td>
</tr>
<tr>
<td>increase (decrease)</td>
<td>Larger (smaller)</td>
</tr>
<tr>
<td>Population size</td>
<td>Virtually no effect</td>
</tr>
</tbody>
</table>

Sample Sizes Using Nonstatistical Sampling. The auditor using nonstatistical sampling for tests of controls uses his or her professional judgment to consider the factors described in paragraph .26 of this section in determining sample sizes.

Reference to firm sample size guidance is sufficient (that is, each team does not need to document inputs that are implicit in the firm’s sample size tables).
sampling parameters.³ It is important to note, however, that auditors are not required to specifically compute a statistical sample size. Nevertheless, auditors might find it helpful to be familiar with the tables in paragraphs .33–.36 of this section. Auditors using these tables as an aid in understanding relative sample sizes for tests of controls will need to apply professional judgment in reviewing the risk levels and expected population deviation rates in relation to sample sizes. Also, an auditor may decide to establish guidelines for sample sizes for tests of controls based on attribute sampling tables.

.30 After completing the examination of the sampling units and summarizing deviations from prescribed controls, the auditor evaluates the results.

- **Calculate the deviation rate.** Calculating the deviation rate in the sample involves dividing the number of observed deviations by the sample size.

- **Consider sampling risk.** When evaluating a sample for a test of controls, consideration may be given to sampling risk.

- **Consider the qualitative aspects of deviations.** In addition to evaluating the frequency of deviations from pertinent controls, the auditor should consider the qualitative aspects of the deviations.

- **Reach an overall conclusion.** The auditor uses professional judgment to reach an overall conclusion about the effect that the evaluation of the results will have on the assessed level of control risk and on the nature, timing and extent of planned substantive tests.

.31 **Sample Sizes Using Statistical Sampling.** The appropriate statistical method for tests of controls is attributes sampling, which is a technique designed to estimate qualitative characteristics of a population. Attributes sampling is most commonly used in auditing to test the rate of deviation from a prescribed control to support the auditor’s assessed level of control risk.

.32 Applying attributes sampling involves performing the following steps:

a. **Decide on the attributes to test.** The tests of controls may include the testing of one or more attributes. Proper evaluation of the results may require testing and evaluating each attribute separately.

b. **Define the population from which the sample items should be selected.** The auditor should make sure that the population is appropriate for the audit objective as described in paragraph .25 of this section.

c. **Specify the following factors:**

- **Acceptable risk of assessing control risk too low.** There is an inverse relationship between the risk of assessing control risk too low and sample size. If the auditor is willing to accept only a low risk of assessing control risk too low, the sample size would ordinarily be larger than if a higher risk were acceptable. When auditors seek high assurance from important controls, the risk is often set at 10 percent or less.

- **Tolerable rate.** Higher assessments of control risk will permit higher tolerable deviation rates. When auditors seek high assurance from important controls, the tolerable deviation rates are generally set at 10 percent or less.

- **Expected population deviation rate.** The auditor’s expectations may be based on prior year’s tests and the control environment. The prior year’s results may be considered in light of changes in the entity’s internal control and changes in personnel. Sample sizes will increase significantly as the expected population deviation rate increases from zero. If the deviation rate in the sample turns out to be higher than the rate specified by the auditor in determining the sample size, the sample results will not support the auditor’s planned assessed level of control risk.

³ This guidance does not suggest that the auditor using nonstatistical sampling compute a corresponding sample size using statistical theory.
d. **Determine the appropriate sample size.** Example sample sizes are found in the tables in paragraphs .33–.34 of this section. The table in paragraph .33 is designed for a risk of assessing control risk too low of 5 percent, and the table in paragraph .34 is designed for a 10 percent risk of assessing control risk too low. With the tolerable rate and the expected population deviation rate, the auditor may find the sample size from the table. The numbers in parentheses are the number of deviations that may be found in the sample and still support the auditor’s planned assessed level of control risk.

e. **Randomly select the sample from the population.** The section beginning at paragraph .60 of this section describes the methods that may be used to select a random sample.

f. **Perform the audit procedures to identify deviations in the sample.**

g. **Calculate the statistical results.** Using the tables in paragraphs .35–.36 of this section or the appropriate risk of assessing control risk too low, determine the actual tolerable deviation rate from the sample size and the actual number of deviations found in the sample.

h. **Reassess the level of control risk.** If the sample results, along with other relevant evidential matter, support the planned assessed level of control risk, the auditor generally does not need to modify planned substantive tests. If the planned assessed level of control risk is not supported, the auditor would ordinarily either perform tests of other controls that could support the planned assessed level of control risk or increase the assessed level of control risk.

i. **Document the Sampling Procedures.** AU section 350 and the AICPA Audit Guide *Audit Sampling* do not require specific documentation of audit sampling applications. See paragraph .10 of this section for certain documentation requirements of AU section 339. Examples of items that the auditor typically documents for tests of controls are discussed in paragraph .25 of this section. Auditors may also refer to the Audit Guide *Audit Sampling* for more information.
### Statistical Sample Sizes for Test of Controls—5 Percent Risk of Overreliance
(With Number of Expected Errors in Parentheses)

<table>
<thead>
<tr>
<th>Tolerable Deviation Rate</th>
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<th>4%</th>
<th>5%</th>
<th>6%</th>
<th>7%</th>
<th>8%</th>
<th>9%</th>
<th>10%</th>
<th>15%</th>
<th>20%</th>
</tr>
</thead>
<tbody>
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<td>149(0)</td>
<td>99(0)</td>
<td>74(0)</td>
<td>59(0)</td>
<td>49(0)</td>
<td>42(0)</td>
<td>36(0)</td>
<td>32(0)</td>
<td>29(0)</td>
<td>19(0)</td>
<td>14(0)</td>
</tr>
<tr>
<td>0.25%</td>
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<td>157(1)</td>
<td>117(1)</td>
<td>93(1)</td>
<td>78(1)</td>
<td>66(1)</td>
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<td>51(1)</td>
<td>46(1)</td>
<td>30(1)</td>
<td>22(1)</td>
</tr>
<tr>
<td>0.50%</td>
<td>313(2)</td>
<td>157(1)</td>
<td>117(1)</td>
<td>93(1)</td>
<td>78(1)</td>
<td>66(1)</td>
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<td>51(1)</td>
<td>46(1)</td>
<td>30(1)</td>
<td>22(1)</td>
</tr>
<tr>
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<td>386(3)</td>
<td>208(2)</td>
<td>117(1)</td>
<td>93(1)</td>
<td>78(1)</td>
<td>66(1)</td>
<td>58(1)</td>
<td>51(1)</td>
<td>46(1)</td>
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<td>22(1)</td>
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<td>46(1)</td>
<td>30(1)</td>
<td>22(1)</td>
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<td>77(2)</td>
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<td>61(2)</td>
<td>30(1)</td>
<td>22(1)</td>
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<td>234(6)</td>
<td>150(4)</td>
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<td>77(2)</td>
<td>68(2)</td>
<td>61(2)</td>
<td>30(1)</td>
<td>22(1)</td>
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<td>173(5)</td>
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<td>95(3)</td>
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<td>30(1)</td>
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<td>84(3)</td>
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<td>458(15)</td>
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<td>3.50%</td>
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<td>167(6)</td>
<td>112(4)</td>
<td>84(3)</td>
<td>76(3)</td>
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<td>185(7)</td>
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<td>100(4)</td>
<td>76(3)</td>
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<td>22(1)</td>
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<td>4.00%</td>
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<td>421(17)</td>
<td>221(9)</td>
<td>146(6)</td>
<td>100(4)</td>
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<td>478(24)</td>
<td>240(12)</td>
<td>158(8)</td>
<td>116(6)</td>
<td>40(2)</td>
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<td>7.00%</td>
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<td>85(7)</td>
<td>37(3)</td>
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<td>9.00%</td>
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<td>10.00%</td>
<td>150(15)</td>
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<td>15.00%</td>
<td>193(29)</td>
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<td></td>
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<td></td>
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</tr>
</tbody>
</table>

*Note: Sample sizes over 2,000 items not shown. This table assumes a large population.*
### Statistical Sample Sizes for Test of Controls—10 Percent Risk of Overreliance
(With Number of Expected Errors in Parentheses)

<table>
<thead>
<tr>
<th>Tolerable Deviation Rate</th>
<th>Expected Deviation Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2%</td>
</tr>
<tr>
<td>0.00%</td>
<td>114(0)</td>
</tr>
<tr>
<td>0.25%</td>
<td>194(1)</td>
</tr>
<tr>
<td>0.50%</td>
<td>194(1)</td>
</tr>
<tr>
<td>0.75%</td>
<td>265(2)</td>
</tr>
<tr>
<td>1.00%</td>
<td>398(4)</td>
</tr>
<tr>
<td>1.25%</td>
<td>708(9)</td>
</tr>
<tr>
<td>1.50%</td>
<td>1,463(22)</td>
</tr>
<tr>
<td>1.75%</td>
<td>390(7)</td>
</tr>
<tr>
<td>2.00%</td>
<td>590(12)</td>
</tr>
<tr>
<td>2.25%</td>
<td>974(22)</td>
</tr>
<tr>
<td>2.50%</td>
<td>353(9)</td>
</tr>
<tr>
<td>2.75%</td>
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</tr>
<tr>
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<td>730(22)</td>
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<tr>
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<td>400(14)</td>
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<td>583(22)</td>
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<tr>
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<td>100(10)</td>
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<tr>
<td>12.50%</td>
<td>368(46)</td>
</tr>
<tr>
<td>15.00%</td>
<td>126(19)</td>
</tr>
<tr>
<td>17.50%</td>
<td></td>
</tr>
</tbody>
</table>

*Note:* Sample sizes over 2,000 items not shown. This table assumes a large population.
### Statistical Sampling Results Evaluation Table for Tests of Controls—Upper Limits at 5 Percent Risk of Overreliance

<table>
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<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>20</td>
<td>14.0</td>
<td>21.7</td>
<td>28.3</td>
<td>34.4</td>
<td>40.2</td>
<td>45.6</td>
<td>50.8</td>
<td>55.9</td>
<td>60.7</td>
<td>65.4</td>
<td>69.9</td>
</tr>
<tr>
<td>25</td>
<td>11.3</td>
<td>17.7</td>
<td>23.2</td>
<td>28.2</td>
<td>33.0</td>
<td>37.6</td>
<td>42.0</td>
<td>46.3</td>
<td>50.4</td>
<td>54.4</td>
<td>58.4</td>
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<td>50.0</td>
</tr>
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<td>12.9</td>
<td>17.0</td>
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<td>27.8</td>
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<td>34.4</td>
<td>37.5</td>
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<td>15.0</td>
<td>18.3</td>
<td>21.5</td>
<td>24.6</td>
<td>27.5</td>
<td>30.4</td>
<td>33.3</td>
<td>36.0</td>
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<td>16.4</td>
<td>19.2</td>
<td>22.0</td>
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<td>27.3</td>
<td>29.8</td>
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**Note:** This table presents upper limits (body of table) as percentages. This table assumes a large population.
### Statistical Sampling Results Evaluation Table for Tests of Controls—Upper Limits at 10 Percent Risk of Overreliance

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**Note:** This table presents upper limits (body of table) as percentages. This table assumes a large population.
Audit Sampling for Substantive Tests of Details

.37 The purpose of substantive tests of details of transactions and balances is to detect material misstatements in the account balance, transaction class, and disclosure components of the financial statements. An auditor assesses the risks of material misstatement and relies on a combination of further control tests, analytical procedures, and substantive tests of details for providing a basis for the opinion about whether the financial statements are materially misstated. When testing the details of an account balance or class of transactions, the auditor might use audit sampling to obtain evidence about the reasonableness of monetary amounts.

.38 The auditor uses professional judgment to determine whether audit sampling is appropriate. Sampling may not always be appropriate. For example, the auditor may decide that it is more efficient to test an account balance or class of transactions by applying analytical procedures.

.39 When an auditor plans any audit sampling application, the first consideration is the specific account balance or class of transactions and the circumstances in which the procedure is to be applied. The auditor generally identifies items or groups of items that are of individual significance to an audit objective and relevant assertion. For example, an auditor planning to use audit sampling as part of the tests of an inventory balance as well as observing the physical inventory would generally identify items that have significantly large balances or that might have other special characteristics.

.40 The auditor considers all special knowledge about the items constituting the balance or class before designing audit sampling procedures. For example, the auditor might identify 20 items that make up 25 percent of the account balance, and decide that those items should be examined 100 percent and excluded from inventory subject to audit sampling. Any items that the auditor has decided to test 100 percent are not part of the population subject to sampling.

.41 A population for audit sampling purposes does not necessarily need to be an entire account balance or class of transactions. In some circumstances, an auditor might examine all the items that constitute an account balance or class of transactions that exceed a given amount or that have an unusual characteristic; the auditor might either (a) apply other auditing procedures (for example, analytical procedures) to items that do not exceed a given amount or possess an unusual characteristic or (b) apply no auditing procedures to them because there is an acceptably low risk of material misstatement existing in the remaining items.

.42 Once a decision has been made to use audit sampling, the auditor may choose between statistical and nonstatistical sampling. The choice is primarily a cost-benefit consideration. Statistical sampling uses the laws of probability to measure sampling risk. Any sampling procedure that does not measure the sampling risk is a nonstatistical sampling procedure.

.43 Determining the test objectives. A sampling plan for substantive tests of details might be designed to (a) test the reasonableness of one or more assertions about a financial statement amount (for example, the existence of accounts receivable) or (b) make an independent estimate of some amount (for example, the last in, first out [LIFO] index for a LIFO inventory). The auditor should carefully identify the characteristic of interest (for example, the misstatement) for the sampling application that is consistent with the audit objective.

.44 Defining the population. The population consists of the items constituting the account balance or class of transactions of interest. The auditor should determine that the population from which he or she selects the sample is appropriate for the specific audit objective because sample results can be projected only to the population from which the sample was selected.

.45 Defining the sampling unit. A sampling unit is any of the individual elements that constitute the population, and depends on the audit objective and the nature of the audit procedures to be applied. A
sampling unit might be a customer account balance, an individual transaction or an individual entry in a transaction. The auditor might consider which sampling unit leads to a more effective and efficient sampling application in the circumstances.

.46 Choosing an audit sampling technique. Either statistical or nonstatistical sampling is appropriate for substantive tests of details. The most common statistical approaches are classical variables sampling and monetary unit sampling.

.47 Determining the method of selecting the sample. The auditor should select the sample in such a way that the sample can be expected to be representative of the population or the stratum from which it is selected.

.48 Determining the sample size. Accounting populations tend to include a few very large amounts, a number of moderately large amounts, and a large number of small amounts. Auditors consider the variation in a characteristic when they determine an appropriate sample size for a substantive test, and, generally, the variation of the items’ recorded amounts as a means of estimating the variation of the audited amounts of the items in the population. A measure of this variation, or scatter, is called the standard deviation. Sample sizes generally decrease as the variation becomes smaller. Sample sizes from unstratified populations with high variation are generally much larger than stratified samples from the same population.

.49 In performing substantive tests of details, auditors are also concerned with two aspects of sampling risk:

a. Risk of incorrect acceptance—the risk that the sample supports the conclusion that the recorded account balance is not materially misstated when it is materially misstated.

b. Risk of incorrect rejection—the risk that the sample supports the conclusion that the recorded amount is materially misstated when it is not. This risk is generally controlled by setting an adequate or conservative estimate of expected misstatement and increasing the sample size accordingly.

.50 When planning a sample for a substantive test of details, the auditor should consider how much monetary misstatement in the related account balance or class of transactions is acceptable without causing the financial statements to be materially misstated. The maximum monetary misstatement for the balance or class is called tolerable misstatement for the sample. For a particular account balance or class of transactions, the sample size required to achieve the auditor’s objective at a given risk of incorrect acceptance increases as the auditor’s assessment of tolerable misstatement for that balance or class decreases.

.51 The auditor also assesses the expected amount of misstatement on the basis of his or her professional judgment after considering such factors as the entity’s business, the results of prior year’s tests of account balances or class of transactions, the results of any pilot sample, the results of any related substantive tests, and the results of any tests of the related controls.

.52 The effect of population size on the appropriate sample size varies according to the audit sampling method used.

.53 Performing the sampling plan. The auditor should apply auditing procedures appropriate for the particular audit objectives to each sample item.

.54 Evaluating the sample results. In evaluating sample results, the auditor should do the following:

• Project the misstatements found in the sample to the population from which the sample was selected and add that amount to the misstatements discovered in any items examined 100 percent.

• Propose known misstatements to management for correction, unless the amounts are trivial.

• Compare the tolerable misstatement for the account balance or class of transactions with the total projected misstatement, adjusted for any corrected misstatements. If the total projected misstatement is less than tolerable misstatement for the account balance or class of transactions, the auditor should consider the risk that such a result might be obtained even though the true monetary misstatement
for the population exceeds the tolerable misstatement. In accordance with paragraph .30 of AU section 350, projected misstatement results for all audit sampling applications and all known misstatements from nonsampling applications should be considered in the aggregate along with other relevant audit evidence when the auditor evaluates whether the financial statements taken as a whole may be materially misstated.

- Consider the qualitative aspects of misstatements. If the sample results suggest that the auditor’s planning assumptions were in error, appropriate action is taken.

.55 Documenting the sampling procedure. AU section 350 and the AICPA Audit Guide Audit Sampling do not require specific documentation of audit sampling applications. See paragraph .10 of this section for certain documentation requirements of AU section 339. Examples of items that the auditor may document for substantive tests include the following:

- The objectives of the test the accounts and assertions affected
- The definition of the population and the sampling unit, including how the auditor determined the completeness of the population
- The definition of a misstatement
- The risk of incorrect acceptance or level of desired assurance (confidence)
- The risk of incorrect rejection, if used
- Estimated and tolerable misstatement
- The audit sampling technique used
- The method used to determine sample size
- The method of sample selection
- Identification of the items selected
- A description of the performance of the sampling procedures and a list of misstatements identified in the sample
- The evaluation of the sample (for example, projection and consideration of sampling risk)
- A summary of the overall conclusion (if not evident from the results)
- Any qualitative factors considered significant in making the sampling assessments and judgments

.56 Nonstatistical sampling for substantive tests of Details. Paragraph .23 of AU section 350 states that to determine the number of items to be selected in a sample for a particular test of details, the auditor should consider the tolerable misstatement and the expected misstatement, the audit risk, the characteristics of the population, the assessed risk of material misstatement (inherent risk and control risk), and the assessed risk for other substantive procedures related to the same assertion. An auditor who applies statistical sampling uses tables or formulas to compute sample size based on these judgments. An auditor who applies nonstatistical sampling uses professional judgment to relate these factors in determining the appropriate sample size. Ordinarily, this would result in a sample size comparable to the sample size resulting from an efficient and effectively designed statistical sample, considering the same sampling parameters.4 It is important to note, however, that auditors are not required to specifically compute a statistical sample size. Nevertheless, auditors might find familiarity with sample sizes based on statistical theory helpful when applying professional judgment and experience in considering the effect of various planning considerations on sample size.

.57 The following table “Factors Influencing Sample Sizes for a Substantive Test of Details in Sample Planning” summarizes the effects of various factors on sample sizes for substantive tests of details. (The table is provided only to illustrate the relative effect of different planning considerations on sample size and is not intended as a substitute for professional judgment).

4 This guidance does not suggest that the auditor using nonstatistical sampling compute a corresponding sample size using statistical theory.
Factors Influencing Sample Sizes for a Substantive Test of Details in Sample Planning

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<th>Related Factor for Substantive Sample Planning</th>
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<td>Virtually no effect on sample size unless population is very small</td>
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</table>

.58 For additional details on audit sampling, including detailed tables, auditors may refer to AICPA Audit Guide *Audit Sampling* and the appendix of AU section 350.

.59 Stratification is particularly important to increasing the efficiency of the sample. If the nonstatistical sample design is planned without stratification, the auditor should increase the sample size. Before selecting the sample, the auditor generally identifies individually significant items and may then select the sample from the remaining items using the systematic selection method, which automatically stratifies the sample, or stratify the remaining items into groups and allocate the sample size accordingly.

.60 *Evaluating the sample results.* The misstatement in the sample should be projected to the items from which the sample was selected. One method of projecting the amount of misstatement found in a sample is to divide the amount of misstatement in the sample by the fraction of total dollars in the population included in the sample. For example, if a $100 misstatement is found in a sample of 10 percent of the population, the projected misstatement would be $1,000 ($100 ÷ .10).

.61 A second method for projecting the misstatement uses the average difference between the audited and the recorded amounts of each item included in the sample. For example, if $200 of misstatement is found in a sample of 100 items, the average difference between audited and recorded amounts for items in the sample is $2 ($200 ÷ 100). An estimate of the amount of misstatement in the population may be calculated by multiplying the total number of items in the population (in this case 5,000 items) by the average difference of $2 for each sample item. The estimate of misstatement in the population is $10,000 (5,000 × 2).
AAM Section 5500

Suggested Supplemental Reference Materials

.01 Suggested Supplemental Reference Materials

The following publications are useful in helping to determine the nature, timing, and extent of audit procedures. To order AICPA products, call (888) 777-7077.

- **Audit and Accounting Guides (AICPA)**
  
  Each guide describes relevant matters, conditions, and procedures unique to a particular industry, and illustrates treatments of financial statements and reports to caution auditors and accountants about unusual problems.

- **Audit Risk Alerts (AICPA)**
  
  Audit Risk Alerts complement the guidance provided in many of the Audit and Accounting Guides by describing current economic, regulatory, and professional developments that can have a significant impact on engagements.

- **Professional Standards (AICPA)**
  
  The publication features the outstanding pronouncements on professional standards issued by the AICPA, including standards for audits, compilations, and reviews.

- **Financial Statement Preparation Manual (AICPA)**
  
  This publication provides sample statements and checklists for a variety of business enterprises and governmental units.

- **Disclosure Checklist series (AICPA)** (individual paperback versions of sections of the Financial Statement Preparation Manual)
  
  The practice aids are invaluable to anyone who prepares financial statements and reports. The material has been updated to reflect AICPA, FASB, and GASB pronouncements and interpretations as well as SEC regulations.

- **Accounting Trends & Techniques (AICPA)**
  
  This publication contains reporting methods based on a cumulative survey, as well as significant accounting presentations, discussions, and trends. By following the lead of these industry front-runners, practitioners can apply the latest techniques and improve their own reporting performance.

- **Fraud Detection in a GAAS Audit (Revised edition) (AICPA)**
  
  This practice aid provides CPAs with the most recent information related to complying with AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1).

- **Technical Practice Aids (AICPA)**
  
  This publication contains all outstanding AICPA Statements of Position and Practice Bulletins and offers carefully thought-out responses to selected inquiries received by the AICPA Technical Hotline and AICPA Technical and Industry Committees.

- **Standard Form to Confirm Account Balance Information with Financial Institutions (AICPA)**
  
  This form may be used to request a full report on credit balance, liabilities, and contingent liabilities. It may also be used for a confirmation of bank balance only.

- **Accountants’ Handbook by Carmichael, Lilien & Mellman (Wiley)**
• Montgomery’s Auditing by O’Reilly, Hirsch, Defliese, and Jaenicke (Wiley)
• Handbook of Modern Accounting by Davidson & Weil (McGraw-Hill)
• Kohler’s Dictionary for Accountants by Coopers & Ijiri (Prentice-Hall)

[The next page is 6001.]
# AAM Section 6000
Audit Documentation

## Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>6100</td>
<td>Audit Documentation—General</td>
</tr>
<tr>
<td></td>
<td>Audit Documentation Retention</td>
</tr>
<tr>
<td></td>
<td>Ownership and Confidentiality of Audit Documentation</td>
</tr>
<tr>
<td></td>
<td>Documentation of Departures From the SASs</td>
</tr>
<tr>
<td></td>
<td>General Discussion</td>
</tr>
<tr>
<td>6200</td>
<td>Form, Content, and Extent of Audit Documentation</td>
</tr>
<tr>
<td></td>
<td>Basic Elements of Format</td>
</tr>
<tr>
<td></td>
<td>General Considerations</td>
</tr>
<tr>
<td></td>
<td>Specific Considerations</td>
</tr>
<tr>
<td></td>
<td>Timesaving Considerations</td>
</tr>
<tr>
<td></td>
<td>Symbols (Tick Marks)</td>
</tr>
<tr>
<td>6300</td>
<td>Organization and Filing (Indexing)</td>
</tr>
<tr>
<td></td>
<td>Predetermined Indexing</td>
</tr>
<tr>
<td></td>
<td>Current and Permanent Files</td>
</tr>
<tr>
<td></td>
<td>Index Topics</td>
</tr>
</tbody>
</table>

[The next page is 6101.]
AAM Section 6100
Audit Documentation—General

.01 Audit documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions reached by the auditor in the engagement. Audit documentation, also known as working papers, may be recorded on paper or on electronic or other media. AU section 339, Audit Documentation (AICPA, Professional Standards, vol. 1), establishes standards and provides guidance on the form, general content, and ownership and confidentiality of audit documentation.

.02 Other Statements on Auditing Standards (SASs) contain specific documentation requirements and can be found in appendix A of AU section 339. Additionally, specific documentation or document retention requirements may be included in other standards (for example, government auditing standards), laws, and regulations applicable to the engagement.

.03 The auditor must prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusions reached. Audit documentation provides the principal support for the representation in the auditor’s report that the auditor performed the audit in accordance with generally accepted auditing standards and provides the principal support for the opinion expressed regarding the financial information or the assertion to the effect that an opinion cannot be expressed.

.04 Among other matters, AU section 339 provides the following:

- The auditor should prepare audit documentation in connection with each engagement in sufficient detail to provide an experienced auditor with no previous connection to the audit a clear understanding of the work performed (including the nature, timing, extent and results of audit procedures performed), the audit evidence obtained and its source, and the conclusions reached.

- Oral explanations on their own do not represent sufficient support for the work the auditor performed or conclusions the auditor reached, but they may be used by the auditor to clarify or explain information contained in the audit documentation.

- The auditor should document significant findings or issues, actions taken to address them (including any additional evidence obtained), the basis for the final conclusions reached, and discussions of the significant findings or issues with management or others, including responses and when and with whom the discussion took place. If the auditor has identified information that contradicts or is inconsistent with the auditor’s final conclusions regarding a significant finding or issue, the auditor should document how the auditor addressed the contradiction or inconsistency.

- The auditor should assemble the audit documentation to form the final audit engagement file on a timely basis but within 60 days following the report release date (also known as the documentation completion date). After this date, the auditor must not delete or discard audit documentation before the end of the specified retention period and should appropriately document any subsequent additions. (Paragraphs .23–.30 of AU section 339 establish standards and provide guidance regarding revisions to audit documentation after the date of the auditor’s report.)

- A file retention period should not be shorter than 5 years from the report release date.

Audit Documentation Retention

.05 AU section 339 states that the auditor should adopt reasonable procedures to retain and access audit documentation for a period of time sufficient to meet the needs of his or her practice and to satisfy any
applicable legal or regulatory requirements for records retention. Such retention period, however, should not be shorter than 5 years from the report release date. Statutes, regulations, or the audit firm’s quality control policies may specify a longer retention period.

.06 Determining the proper periods for retaining records is a major decision for practitioners. Records may be preserved for only as long as they serve a useful purpose or until all legal requirements are met. Record retention periods vary among firms; however, retention periods generally correspond with the longest statute of limitations prevailing in each state for breach of contract, breach of fiduciary duty, and professional liability claims.

.07 Audit documentation may be retained permanently or for periods corresponding with the longest state statute of limitations, as noted in the previous paragraph. Generally, certain audited financial statement working paper data, such as accounts receivable confirmations, are destroyed after 10 years. Examples of audit documentation that the auditor may wish to retain permanently include auditor’s reports, reports filed with the Securities and Exchange Commission, tax returns for current clients, and audit documentation for current clients. Some firms divide the retention period into 2 parts, records are first filed in the office and later placed in storage (for example, 3 years in the office and then permanently in storage). Other records, such as audit documentation files for former clients, may be retained for 3 years in the office, 7 years in storage, and then destroyed after the retention period has ended. The auditor may obtain specific approval of the engagement partner before destroying any audit documentation. An annual schedule may be established for reviewing and purging firm data. Because there is substantial variation in the retention periods used by firms, each firm may carefully consider its requirements and consult with legal counsel before adopting a retention period.

.08 For further guidance on record retention, see the AICPA Management of an Accounting Practice Handbook (online subscription product no. MAP-XX).

Ownership and Confidentiality of Audit Documentation

.09 Audit documentation is the property of the auditor, and some states recognize this right of ownership in their statutes.

.10 The auditor has an ethical, and in some situations a legal, obligation to maintain the confidentiality of client information. Because audit documentation contains confidential client information, the auditor should adopt reasonable procedures to maintain the confidentiality of that information.

.11 Whether audit documentation is in paper, electronic, or other media, the integrity, accessibility, and retrievability of the underlying data may be compromised if the documentation could be altered, added to, or deleted without the auditor’s knowledge or could be permanently lost or damaged. Accordingly, the auditor should apply appropriate and reasonable controls for audit documentation to

a. clearly determine when and by whom audit documentation was created, changed, or reviewed;

b. protect the integrity of the information at all stages of the audit, especially when the information is shared within the audit team or transmitted to other parties via electronic means;

c. prevent unauthorized changes to the documentation; and

d. allow access to the documentation by the audit team and other authorized parties as necessary to properly discharge their responsibilities.

Documentation of Departures From the SASs

.12 In rare circumstances when the auditor departs from a presumptively mandatory requirement in the SASs, he or she must document the justification for the departure and how the alternative procedures in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement.
General Discussion

.13 These sections present points of view on the organization and preparation of audit documentation.

.14 Proper planning is important in the design of specific audit documentation if the documentation is to serve the objective of aiding the auditor in the conduct of his or her work. For example, a well-planned working paper may be designed to provide information that will be needed later in the preparation of tax returns and other required reports, such as those to regulatory bodies, and may therefore eliminate the need for examining the same documents twice to obtain necessary information. The form, content, and extent of audit documentation are matters of the auditor’s professional judgment and depend on the circumstances of the engagement and the audit methodology and tools used. The individual preferences of auditors and firms may be informal common practices or expressed as part of a firm’s formal policies and procedures. A firm may consider the nature of its practice and the services commonly provided to its clients, in addition to professional standards, in developing its procedures and policies on audit documentation. Those procedures and policies may permit the flexibility necessary to meet the needs of individual engagements.

[The next page is 6201.]
AAM Section 6200

Form, Content, and Extent of Audit Documentation

.01 The form, content, and extent of audit documentation vary with the circumstances and needs of the auditors on individual engagements. Some firms, however, include various general and specific instructions on audit documentation content in their policies concerning the working papers.

.02 Examples of audit documentation are audit programs, analyses, issues, memoranda, summaries of significant findings or issues, letters of confirmation and representation, checklists, abstracts or copies of important documents, correspondence (including e-mail), and schedules or commentaries prepared or obtained by the auditor. Abstracts or copies of the entity’s records should be included as part of the audit documentation if they are needed to enable an experienced auditor to understand the work performed and conclusions reached. Audit documentation may be in paper form, electronic form, or other media.

.03 The auditor should prepare audit documentation that enables an experienced auditor, having no previous connection to the audit, to understand

a. the nature, timing, and extent of auditing procedures performed to comply with Statements on Auditing Standards and applicable legal and regulatory requirements, including (1) who performed the audit work and the date such work was completed and (2) who reviewed specific audit documentation and the date of such review;

b. the results of the audit procedures performed and the audit evidence obtained;

c. the conclusions reached on significant matters; and

d. that the accounting records agree or reconcile with the audited financial statements or other audited information.

.04 In determining the form, content, and extent of audit documentation, the auditor should consider the following factors:

- The nature of the auditing procedures to be performed
- The identified risk of material misstatement associated with the assertion or account or class of transactions, including related disclosures
- The extent of judgment involved in performing the work and evaluating the results
- The significance of the audit evidence obtained to the assertion being tested
- The nature and extent of exceptions identified
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or evidence obtained

Basic Elements of Format

.05 Audit documentation formats generally include at least the following for identification purposes:

- A title or heading including (a) the name of the client, (b) a caption that briefly describes the paper’s contents, (c) the nature of the engagement, and (d) the applicable period or closing date covered by the engagement
• The initials or names of the auditors who performed and reviewed the work presented in the paper and the date the paper was completed.

.06 In instances when audit documentation extends beyond 1 page, some auditors present the heading on only the lead page and fasten or staple all the applicable pages together as a unit and number each page (for example, 1 of 5, 2 of 5, and so forth). Many auditors index each working paper in some organized preestablished manner. This provides for ease in cross-referencing to other relevant papers, for more organized indexing and filing, and for a form of control over the audit documentation. (See AAM section 6300, Organization and Filing (Indexing).)

.07 Some auditors purchase standard analysis paper that includes preprinted blocks for the initials or signature of the preparer and reviewer and the dates on which the paper was prepared and reviewed. Others design their own signature and reference blocks and have them imprinted on all of their analysis paper and lined pads. These signature blocks may include captions such as the following:

• Prepared by client and tested by
• Prepared by
• Date prepared
• Date tested
• Reviewed by
• Date reviewed
• Source
• Audit documentation reference
• Footed by
• Extensions checked by

.08 Some auditors prefer to identify client preparation of schedules and analysis by notations or codes, such as PBC (prepared by client), rather than use a detailed signature and reference block.

General Considerations

.09 The following are some general considerations on audit documentation content that may be helpful:

• The auditor may include identification of the (a) source of the information presented (for example, fixed assets ledger or cash disbursements journal), (b) the nature and extent of the work done and conclusions reached (by symbols and legend, narrative, or a combination of both), and (c) appropriate cross-references to other working papers in the content of an individual working paper or group of related papers.

• The auditor should document significant findings or issues, actions taken to address them, and the basis for the final conclusions reached. If for some reason the auditor leaves the assignment before resolving all items, he or she may provide an open items listing on a separate temporary paper for the in-charge auditor’s attention. An unresolved exception or incomplete explanation in the working papers may be construed by some as indication of an inadequate audit.

• Information and comments in the audit documentation generally represent statements of fact and professional conclusions. Accordingly, the auditor may wish to refrain from using vague judgmental adjectives such as good or bad. Conclusions should be supported by documented facts, especially if they concern the adequacy of the client’s records.

• Working papers are an integrated presentation of information. The auditor may find it useful to cross-reference working papers to call attention to inter-account relationships and to reference a paper to other working papers summarizing or detailing related information.
• All inferences and conclusions should be supported in the working papers, and no misleading or irrelevant statements should be made.
• It is preferable to have negative figures in audit documentation indicated by parentheses instead of red figures to preserve their identity if the papers are photocopied or microfilmed.

Specific Considerations

.10 As mentioned in the preceding section, abstracts or copies of the entity’s records should be included as part of the audit documentation if they are needed to enable an experienced auditor to understand the work performed and conclusions reached. Additionally, audit documentation of procedures performed, including tests of operating effectiveness of controls and substantive tests of details that involve inspection of documents or confirmation should include the identifying characteristics of the specific items tested.

.11 Furthermore, the auditor should document significant findings or issues, actions taken to address them (including any additional evidence obtained), and the basis for the final conclusions reached. Significant audit findings or issues include, but are not limited to, the following:
• Significant matters involving the selection, application, and consistency of accounting principles with regard to the financial statements, including related disclosures. Such matters include, but are not limited to, (1) accounting for complex or unusual transactions or (2) accounting estimates and uncertainties and, if applicable, the related management assumptions.
• Results of auditing procedures that indicate that the financial statements or disclosures could be materially misstated or a need to revise the auditor’s previous assessment of the risks of material misstatement and the auditor’s responses to those risks.
• Circumstances that cause significant difficulty in applying auditing procedures that the auditor considered necessary.
• Findings that could result in modification of the auditor’s report.
• Audit adjustments. For purposes of AU section 339, Audit Documentation (AICPA, Professional Standards, vol. 1), an audit adjustment is a correction of a misstatement of the financial information that is identified by the auditor, whether or not recorded by management, that could, either individually or when aggregated with other misstatements, have a material effect on the company’s financial information.

Timesaving Considerations

.12 There are a number of ways to save time and avoid unnecessary detail in audit documentation preparation. For example, the auditor may consider the following examples:
• Whenever possible, have the client’s employees prepare schedules and analyses. This, of course, presupposes that the client has the necessary personnel to prepare the materials.
• Use a detailed audit program that may eliminate the need for lengthy comments in the audit documentation on the scope of audit procedures. However, some believe that such comments are still necessary when a detailed program is used; this is a matter of individual firm judgment.
• Analyze asset (or liability) accounts and their related expense or income accounts on the same working paper. Examples include property, plant, and equipment; accumulated depreciation and related depreciation expense; notes receivable; accrued or prepaid interest receivable and interest income; notes payable; accrued or prepaid interest and interest expense; and accrued taxes and related provisions for tax expense.
• Avoid unnecessary computations. For example, if only the totals are meaningful and can be tested by a single independent computation, check the total and avoid the unnecessary checking of details.
• Consider using carryforward analyses for accounts that tend to remain constant each year or vary only in accordance with a constant predetermined formula. Examples may include long term assets and related depreciation or amortization such as plant, equipment, and intangibles; long term debt with predetermined payment schedules; and capital stock.

• Use symbols (tick marks) whenever possible, especially when the same symbol applies to several working papers.

Symbols (Tick Marks)

.13 When using symbols, it may be helpful to consider the following basic concepts:

• Symbols are merely a shorthand means of explaining a work step performed on a particular item of data. Symbols serve as means of conserving time and space and, if properly used, may ease review of the audit documentation.

• For a working paper to be clear to a reviewer or other reader, it is important that each symbol be clearly explained. The explanation may be located on the same page as the items subjected to the work step or on a separate legend that is clearly cross-referenced to and from the page that presents the applicable items.

• Simple, distinctive, and clear symbols can be quickly written by the preparer and easily identified by a reviewer.

.14 Applying these basic concepts is not that simple. Various auditors have conflicting notions about symbols. For example, some believe a set of standardized symbols can expedite preparation and review. Others believe that a set of standardized symbols is impractical because it lacks flexibility. Because it is generally agreed that symbols are an effective timesaver, it is desirable for firms to establish and communicate a policy on their use to maximize their potential effectiveness.

.15 The most commonly used symbols are variations on a simple checkmark—for example, a checkmark with a slash, a checkmark with a circle at the end, a double checkmark, and any one of these within a circle. This abbreviated listing alone provides eight distinctive tick marks. Symbols may also include circled letters or numbers.

[The next page is 6301.]
AAM Section 6300

Organization and Filing (Indexing)

.01 Some auditors organize their audit documentation during the course of an engagement into general categories such as the following:

- Planning and administration
- Internal control understanding and assessment of control risk
- Substantive test audit documentation arranged in order of the balance sheet and income statement classifications
- Trial balances, consolidating working papers, journal entries (adjustments, reclassifications, eliminations for consolidation), and potential entries
- Draft reports, financial statements, and notes
- Programs, checklists, and questionnaires (some keep these as separate units, and others interfile them among working papers by statement classifications)
- General matters such as current minutes, contracts, and articles of incorporation that may apply to future engagements as well as current work

Under this approach, actual indexing and filing may be deferred until the conclusion of the engagement.

Predetermined Indexing

.02 Other practitioners and firms may use a predetermined indexing approach so that working papers can be indexed while the field work is still in progress. This offers the following advantages:

- Better control over audit documentation during the performance of field work
- Constant arrangement of audit documentation in logical order to aid in review
- Less time required in assembling and filing them into indexed files
- Quicker access to specific audit documentation after it is filed

.03 Predetermined indexing involves establishing a standard code for each section of the audit documentation using letters and numbers or numbers only. See the following table for an example.

<table>
<thead>
<tr>
<th>Two Possible Alternatives</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Working trial balance—assets</td>
<td>B/S-A</td>
</tr>
<tr>
<td>Working trial balance—liabilities</td>
<td>B/S-L</td>
</tr>
<tr>
<td>Working trial balance—income and expense</td>
<td>P/L</td>
</tr>
<tr>
<td>Cash summary schedule</td>
<td>A</td>
</tr>
<tr>
<td>Receivables summary schedule</td>
<td>B</td>
</tr>
<tr>
<td>Inventory summary schedule</td>
<td>C</td>
</tr>
</tbody>
</table>

.04 Predetermined indexing requires recognition of the need for flexibility to meet unanticipated audit documentation needs or specialized industry requirements, and it requires care to avoid undue complexity.
Excessively complex references may obstruct rather than ease audit documentation preparation, cross-referencing, and filing. Accordingly, it is helpful to develop an organizational plan adaptable to each section of the audit documentation. For example, some accountants classify working papers as lead schedules, primary detail, and secondary detail that might result in the following classification scheme for the preceding examples for cash:

<table>
<thead>
<tr>
<th>Classification</th>
<th>Using Letters and Numbers</th>
<th>Using Only Numbers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lead schedule</td>
<td>(A)</td>
<td>(10)</td>
</tr>
<tr>
<td>Primary detail schedules</td>
<td>(A-1) (A-2) and so forth</td>
<td>(10-1) (10-2) and so forth</td>
</tr>
</tbody>
</table>

Predetermined (standardized) indexing systems may be printed on separate pages for reference during the performance of field work and insertion in the front of audit documentation binders or files when the work is completed. Some firms have their uniform indexing systems printed directly on their file or binder covers.

A well-organized indexing system need not be too complex. On a fairly small engagement, the indexing system may be a lead schedule divider tab between each major group of accounts with the name of the account on it (for example, cash or accounts receivable) with the related working papers filed behind the lead schedule without being individually indexed. At the completion of the engagement, the pages can be consecutively numbered within each account group (for example, 1 of 10, 2 of 10, and so forth). Because there typically are not numerous or complex layers of supporting schedules, extensive cross-referencing can be avoided.

On large engagements, particularly those with detailed charts of accounts, firms may consider it necessary to develop more complex indexing systems. In one such system, standard index number series are assigned as follows:

- Current audit documentation 1000–7000
- Permanent file 7100–9999

In this system, each index number has 4 digits, with the addition of decimals if necessary. Numbers ending with double zero are reserved for lead schedules whose total agrees with a line item on the working trial balance (index 1400). Single zeros are used for specific types of accounts (such as 2010, petty cash funds).

Certain index numbers can be permanently assigned to each major financial statement classification. For instance, index 2000 may be assigned to cash. If various bank accounts exist, the cash schedules are assigned index numbers 2002, 2003, and so forth. Documentation, such as supporting confirmations and lists of outstanding checks, would be assigned index numbers commencing with 2001.1, 2001.2, and so forth. As for the permanent audit documentation file, index 9300, for example, may be assigned to internal control. Accordingly, flowcharts and related questionnaires would be assigned index numbers in that series.

Current and Permanent Files

Audit documentation files are generally classified as current files and permanent (continuing) files. Current files contain information that is pertinent to a single engagement. Permanent files include information relevant to several recurring engagements. Some firms have their binder or file covers preprinted as current or permanent accompanied by pertinent portions of their uniform audit documentation indexes.
A common challenge to many auditors is to keep the permanent file complete, current, and free from outdated or irrelevant materials that belong in an inactive file of superseded materials.

Some auditors who have confronted many unwieldy permanent files believe that it is better to classify all audit documentation as current with certain materials designated as matters of continuing interest to be carried forward each year until they become outdated. Under this approach, a firm may preprint its complete index on 1 type of file or binder cover and provide space to indicate whether specific contents are continuing or carry forward in nature. Regardless of the approach used, it is important to recognize that the provisions of AU section 339, Audit Documentation (AICPA, Professional Standards, vol. 1), apply to current year audit documentation maintained in any type of file (this includes permanent files) if such documentation serves as support for the current year’s audit report.

The requirements and guidance in AU section 339 also apply to permanent files. Accordingly, permanent files should be reviewed and updated, as needed, in conjunction with the annual audit. Examples of documents that may be found in permanent files are listed in paragraph .07 of AAM section 6100.

Practice Tip
The audit documentation files should contain copies of final executed documents when needed to enable an experienced auditor to understand the work performed and conclusions reached. Any drafts or unsigned versions of documents should be replaced with final versions.

Index Topics
The following is a list of topics to consider in developing a standard index for audit documentation. This list is detailed, but it is by no means all inclusive. For example, specialized industries such as life insurance and banking need other specialized topics. Several of the topics may be eliminated, condensed, or expanded depending on the auditor’s needs and preferences:

Planning and administration
- Time and budget data
- General correspondence and memos
- Memos—current
- Notes and copies for use in next engagement
- Engagement letters
- Schedules and analyses to be prepared by client
- Minutes
- Checklist of an administrative nature if required by firm policy

Audit or work program

Matters of continuing concern
- Client’s industry—background
- Description and brief history of client
- Data and ratio analysis of client’s operations

Alternate practices of filing audit programs include
(a) putting the program in a binder that is separate and distinct from current and permanent files;
(b) putting the signed-off program in the current file; and
(c) keeping a master copy of the program in the permanent file with the signed off copies dispersed among the related audit documentation segments in the current file.
• Client’s facilities
• Articles of incorporation
• Bylaws
• Current contracts and agreements
  — Debt agreements
  — Leases
  — Labor contracts
  — Agreements with officers and key people
  — Pension plans
  — Profit-sharing plans
  — Stock warrants
  — Stock options
  — Other agreements
  — Client’s accounting policies and procedures
  — Carryforward analyses

Internal control
• Internal control questionnaire, narrative, flowcharts, and so forth
• Initial assessment of control risk memos
• Tests of controls

Reports, financial statements and footnotes, trial balances, and assembly sheets
• Reports and financial statements (including letters, if any, on reportable conditions in internal control)
• Consolidating working papers
• Consolidation eliminating entries
• Trial balance
• Adjusting journal entries
• Reclassification journal entries
• Recap of possible adjusting entries
• Assembly sheets supporting footnote disclosures (if the information is not included elsewhere in the audit documentation)
• Disclosure checklists (if required by firm policy)
• Supporting schedules (if required for reports to regulatory bodies or other reports)
• Tax return information and work sheets

2 Certain classifications may lend themselves to carry-forward audit documentation. Examples include allowances for doubtful accounts, brief summaries of confirmation response statistics, accumulated depreciation and amortization, deferred income taxes and open tax positions, long term debt, and capital accounts.
3 Internal control questionnaires may be filed as separate binders or as part of current of permanent files.
4 Some firms and practitioners keep tax return preparation working papers in files that are completely separate from other types of engagement working papers.
Assets

- Cash
- Marketable securities (and related income)
- Notes receivable (and related interest)
- Accounts receivable
  - Summary and analyses
  - Confirmation procedures
- Allowance for doubtful accounts and notes
- Inventories
  - Summary and analysis
  - Price tests, cost, and market
  - Obsolescence review
  - Observation, test counts, and cutoff data
  - Last in, first out determinations
- Prepaid expenses
- Other current assets
- Investments
- Property, plant and accumulated depreciation, and depletion and amortization
- Intangible deferred charges and amortization
- Other assets
- Intercompany accounts

Liabilities

- Notes payable (and related interest)
- Accounts payable
- Accrued liabilities other than income taxes
- Accrued income taxes (both current and deferred), related provisions, and credits
  - Federal
  - State and local
- Other current liabilities
- Long-term debt (including current maturities and capitalized leases)
- Other long-term liabilities
- Deferred income

Commitments and contingencies

- Attorney’s letters
- Abstractors of commitments and contingencies noted during review of minutes, contracts and agreements, confirmation responses, and so forth

---

5 For situations involving voluminous responses or bulk inventory listings, the bulk materials may be filed in separate binders that are cross referenced to the pertinent audit documentation (for example, accounts receivable, accounts payable, and inventory).
• Subsequent events review
• Management representation letter

Equity (capital accounts)
• Capital stock
• Additional paid-in capital
• Treasury stock
• Retained earnings
• Partnership capital

Revenue and expenses
• Operating revenues
• Cost of sales
• Selling, general and administrative
• Other operating expenses
• Other income
• Other expense
• Extraordinary and unusual items
• Secondary schedules
  — Maintenance and repairs
  — Taxes other than income taxes
  — Rents
  — Royalties
  — Advertising costs
  — Legal fees
  — Interest expense recap

[The next page is 7001.]
These samples are presented for illustrative purposes only. They are intended as mere conveniences for users of this manual who may want points of departure when designing their own formats to meet their individual needs. These illustrations are neither all inclusive nor are they prescribed minimums. Auditors and accountants are to rely on professional standards and their individual professional judgment in determining what may be needed in the circumstances.

<table>
<thead>
<tr>
<th>Section</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>7100 Control of Confirmations and Correspondence</td>
<td>.01-.09</td>
</tr>
<tr>
<td>7200 Requests for Confirmations and Related Materials</td>
<td>.01-.30</td>
</tr>
<tr>
<td>7200 Wording of Confirmation Request Forms</td>
<td>.01-.30</td>
</tr>
<tr>
<td>7300 Inquiries to Legal Counsel</td>
<td>.01-.03</td>
</tr>
<tr>
<td>7400 Management Representations and Representation Letters</td>
<td>.01-.17</td>
</tr>
<tr>
<td>7400 Specific Representations</td>
<td>.03</td>
</tr>
<tr>
<td>7400 Materiality Considerations</td>
<td>.04</td>
</tr>
<tr>
<td>7400 Addressing and Dating</td>
<td>.05</td>
</tr>
<tr>
<td>7400 Management’s Signatures</td>
<td>.06</td>
</tr>
<tr>
<td>7400 Scope Limitations</td>
<td>.07</td>
</tr>
<tr>
<td>7400 Illustrative Representation Letter—Audit of Financial Statements</td>
<td>.08-.17</td>
</tr>
<tr>
<td>7500 Communication With Those Charged With Governance</td>
<td>.01-.09</td>
</tr>
<tr>
<td>7500 Matters to Be Communicated</td>
<td>.02-.03</td>
</tr>
<tr>
<td>7500 The Communication Process</td>
<td>.04-.07</td>
</tr>
<tr>
<td>7500 Additional Communication Requirements</td>
<td>.08-.09</td>
</tr>
<tr>
<td>7600 Reliance Letter</td>
<td>.01</td>
</tr>
<tr>
<td>7700 Proposal Letter</td>
<td>.01</td>
</tr>
</tbody>
</table>

[The next page is 7101.]
AAM Section 7100

Control of Confirmations and Correspondence

.01 Generally, clients prepare correspondence and confirmation requests on their own letterhead and submit to the auditor the signed originals and copies. The auditor may obtain one or more copies to serve as file copies for the current audit documentation, second requests, and manuscript copies for the next engagement.

.02 There are two types of confirmation requests: the positive form and the negative form. Some positive forms request the respondent to indicate whether he or she agrees with the information stated on the request. Other positive forms, referred to as blank forms, do not state the amount (or other information) on the confirmation request, but request the recipient to fill in the balance or furnish other information.

.03 The negative form requests the recipient to respond only if he or she disagrees with the information stated on the request. Negative confirmation requests may be used to reduce audit risk to an acceptable level when (a) the combined assessed level of inherent and control risk is low, (b) a large number of small balances is involved, and (c) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration.

.04 The confirmation requests could be reviewed to the extent the auditor considers necessary. For example, the auditor may perform the following for accounts receivable confirmation requests before they are mailed:

- Compare the names and addresses to the client’s records
- Compare balances per confirmation requests to the subsidiary ledger

.05 The requests may then be stuffed in envelopes and submitted to the post office under the auditor’s control.\(^1\)

.06 The auditor should control the mailings and receipt of responses so that the confirmation process is independent of the client.

.07 The auditor may consider including the firm’s office or post office box number as the return address on mailing envelopes so that undeliverable letters are returned to the auditor and not to the client. For mailings, the auditor may provide the envelopes or affix a label on the client’s envelope that covers the client’s return address and replaces it with the auditor’s address.

.08 Reply envelopes addressed to the auditor may be enclosed with the request letter. Reply envelopes generally have prepaid postage to encourage responses. Some auditors also use codes on the reply envelopes so that responses may be sorted by engagement before the mail is opened. This feature may be particularly useful when there are several engagements that involve voluminous mailings.

\(^1\) Interpretation No. 1, “Use of Electronic Confirmations,” of AU section 330, The Confirmation Process (AICPA, Professional Standards, vol. 1, AU sec. 9330 par. .01–.08), states that properly controlled electronic confirmations may be considered to be reliable audit evidence and discusses auditor considerations when using electronic confirmations.
If the client objects to use of the auditor's name and address, some auditors suggest that a post office box in the client's name be used, with the returns to be opened under the auditor's control for the confirmation process, and that the post office be instructed that after the box is closed subsequent mail be forwarded to the auditor.

[The next page is 7201.]
AAM Section 7200

Requests for Confirmations and Related Materials

Wording of Confirmation Request Forms

.01 Forms and correspondence used for confirmation requests should state clearly that the client is requesting that a reply be sent to the CPA. Forms and correspondence used for information requests for engagements other than audits should not refer to “an audit.” They should also use the term accountant(s) rather than auditors. Suggested wording follows:

Please send the following information to our certified public accountants [name and address of accountants] who are performing accounting services for the company.

.02 The samples of correspondence in this section include language that refers to auditors and an audit of the client’s financial statements on the assumption that an audit is being performed. This language needs to be modified if services other than an audit are being performed.
.03 Request for Bank Cutoff Statement

[Prepared on Client’s Letterhead]

[Date]

Financial Institution Official
First United Bank
Anytown, USA 00000

In connection with an audit of the financial statements of [name of client] as of [balance sheet date] and for the [period] then ended, we request that you send the following information directly to our auditors [name and address of auditors] as of close of business [balance sheet date]:

1. The information requested on the enclosed standard form(s) to confirm account balance information with your financial institution.

2. For the following account numbers, statement(s) of our account(s) and the related paid checks for the period from [balance sheet date] to [two weeks subsequent to the balance sheet date] inclusive.

<table>
<thead>
<tr>
<th>Account Number</th>
<th>Account Name</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sincerely,
[Name of Customer]

_______________________
By:____________________

Notes:

(A) This letter should be addressed to a financial institution official who is responsible for the financial institution’s relationship with the client or who is knowledgeable about the transactions or arrangements. Some financial institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function. Independent auditors should ascertain the appropriate recipient.

(B) The request could be sent at least ten days prior to the audit date so the bank will be able to provide the information requested and to render the cutoff statements as requested. If the request does not reach the bank before the cutoff date, the cutoff statement will include transactions after that date.

(C) The letter may also include requests for the following:
- Confirmation of all securities or other items held for the client’s account as of the closing date for collection or safekeeping, or as agent or trustee (a listing should be provided including titles and account numbers).
- Confirmation of the list of authorized signers for the listed accounts. (This may have been previously requested at a preliminary date in connection with assessment of control risk.)
.04 Standard Form to Confirm Account Balance Information With Financial Institutions

STANDARD FORM TO CONFIRM ACCOUNT BALANCE INFORMATION WITH FINANCIAL INSTITUTIONS

CUSTOMER NAME

Financial Institution’s Name and Address

We have provided to our accountants the following information as of the close of business on _________, 20___, regarding our deposit and loan balances. Please confirm the accuracy of the information, noting any exceptions to the information provided. If the balances have been left blank, please complete this form by furnishing the balance in the appropriate space below. Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other deposit and loan accounts we may have with you comes to your attention, please include such information below. Please use the enclosed envelope to return the form directly to our accountants.

1. At the close of business on the date listed above, our records indicated the following deposit balance(s):

<table>
<thead>
<tr>
<th>ACCOUNT NAME</th>
<th>ACCOUNT NO.</th>
<th>INTEREST RATE</th>
<th>BALANCE*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2. We were directly liable to the financial institution for loans at the close of business on the date listed above as follows:

<table>
<thead>
<tr>
<th>ACCOUNT NO./DESCRIPTION</th>
<th>BALANCE*</th>
<th>DATE DUE</th>
<th>INTEREST RATE</th>
<th>DATE THROUGH WHICH INTEREST IS PAID</th>
<th>DESCRIPTION OF COLLATERAL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(Customer’s Authorized Signature)  
(Date)

The information presented above by the customer is in agreement with our records. Although we have not conducted a comprehensive, detailed search of our records, no other deposit or loan accounts have come to our attention except as noted below.

(Financial Institution Authorized Signature)  
(Date)  

[Title]

EXCEPTIONS AND/OR COMMENTS

Please return this form directly to our accountants:

[ ]

* Ordinarily, balances are intentionally left blank if they are not available at the time the form is prepared.

[ ]
.05 Request for Confirmation of Petty Cash Fund and Advances to Employees

[Prepared on Client’s Letterhead]

[Date]

[Name]

[Address]

Our auditors [name and address of auditors] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the balance of the petty cash fund (or amount of advances) in your possession as of December 31, 20XX which was shown by our records as $_______.

Please indicate in the following space provided whether the amount above agrees with your records. If not, please send the auditors any information you have that will help them reconcile the difference.

After signing and dating your reply, please return it directly to the auditors. A stamped, addressed enveloped is enclosed for your convenience.

Sincerely,

[Client’s Authorized Signature]

The foregoing information is in agreement with my records as of December 31, 20XX with the following exceptions (if any):

____________________________________________________

____________________________________________________

____________________________________________________

Date:_____________________________  Signed:________________________
.06 Securities and Cash in Custodian or Trust Accounts

[Prepared on Client’s Letterhead]

[Date]

[Name of Custodian or Trustee]

[Address]

Our auditors, [name and address of auditors] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the enclosed list of securities owned at [date] and the amount of principal and income of cash held by you at that date for each of the following accounts:\(^1\)\(^2\)

[If a list is not obtained from the client, the auditor may complete the following for each account:

<table>
<thead>
<tr>
<th>Name of Account</th>
<th>Account No.(^3)</th>
<th>Amount Held</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.______________</td>
<td>___________________</td>
<td>____________</td>
</tr>
<tr>
<td>2.______________</td>
<td>___________________</td>
<td>____________</td>
</tr>
<tr>
<td>3.______________</td>
<td>___________________</td>
<td>____________</td>
</tr>
</tbody>
</table>

Please also indicate to the auditors whether or not to your knowledge any of the securities are pledged or otherwise encumbered.

Please mail your reply directly to the auditors. A stamped, addressed envelope is enclosed for your convenience.

Sincerely,

[Client’s Authorized Signature]

\(^1\) This letter may be expanded, if necessary, to request cutoff statements of activity (principal and interest) in the accounts.

\(^2\) Sometimes this request is combined with a request for cutoff bank statements and the standard form to confirm account balance information with financial institutions. However, it may be more practical to send separate letters because a bank’s commercial banking and trust departments are usually separate operations.

\(^3\) Use the custodian or trustee’s account number.
.07 Securities Held by Brokers

[Prepared on Client’s Letterhead]

[Date]

[Broker’s Name]

[Address]

In connection with the audit of our financial statements, please send directly to our auditors [name and address of auditors], a statement of our account(s) with you as of [date], indicating the following information:

1. Securities held by you for our account
2. Securities out for transfer to our name
3. Any amounts payable to or due from us

Please mail your reply directly to the auditors. A stamped, addressed envelope is enclosed for your convenience.

Sincerely,

[Client’s Authorized Signature]

____________________________________________________________________

Notes:

(A) The request may be sent so it reaches the broker sufficiently in advance of the listing date for the broker to respond in a practical manner.

(B) It may be helpful to include the account number(s) used by the broker for the client’s account(s).
.08 Sample Receipts for Return of Cash or Securities Counted by Auditor’s Representative and Cutoff Bank Statements Received Directly by the Auditors

Cash Count

The above detailed items were counted in my presence and returned to me intact by [individual's name], representative of [auditor’s firm name].

[Date and Time]  
Custodian: ________________________________
[Custodian’s Signature]

Securities Count

Received intact from [individual’s name], representative of [auditor’s firm name], the securities listed above contained in [Box ______] of the [name of bank or custodian] which were counted by him or her in my presence (or presented to him or her for count).

Date and Time: ____________________  
Signed: ________________________________
Title: _________________________________

Cutoff Bank Statement(s)

Received intact from [individual’s name], representative of [auditor’s firm name], the cutoff bank statements and related paid checks for the [period date range] for the accounts listed in the following space provided:

Date and Time: ____________________  
Signed: ________________________________
Title: _________________________________

Notes:

(A) The auditor may request that receipt(s) be written and signed in ink.

(B) For counts of petty cash funds, the receipt may be written directly on the bottom of the petty cash-count working paper. For security counts and returns of cutoff bank statements, the receipt may be prepared as a separate working paper.
.09 Accounts Receivable—Positive

[Prepared on Client’s Letterhead]

[Date]

[Customer Name]

[Address]

In connection with the audit of our financial statements, please confirm directly to our auditors [name and address of auditors] the amount of your indebtedness to us which according to our records as of [date] amounted to $______.

If the amount shown is in agreement with your records, please check “A.”

If the amount is not in agreement with your records, please check and complete “B.”

After checking the appropriate response, please sign and date your reply and mail it directly to our auditors in the enclosed envelope. DO NOT SEND ANY PAYMENTS to our auditors.

Sincerely,

[Client’s Authorized Signature]

A__________ The balance above agrees with my records.

B__________ My records show a balance of $______.

The difference may be due to the following:

____________________________________

____________________________________

____________________________________

____________________________________

____________________________________

______________________________

[Signed by]

______________________________

[Date]
.10 Accounts Receivable—Negative

[May be a sticker or stamp used on client’s statements to customers]

PLEASE CHECK THIS STATEMENT
If this statement is not correct please write promptly (using the enclosed envelope), giving details of any differences, directly to our auditors, who are now conducting an audit of our financial statements.

[Name of auditors]

[Address of auditors]

If you do not write to our auditors, they will consider this statement to be correct.
Remittances should NOT be sent to the auditors.

Notes:

(A) A negative confirmation may also be requested in letter form using similar wording.

(B) The auditor may consider sending confirmation requests at the time of the client’s regular monthly billings. Coordination of confirmation procedures with the client’s routine preparation and mailing of statements may offer efficiency to both the auditor and client.

(C) Negative confirmation requests may be used as substantive procedure to reduce audit risk only when three conditions exist: (1) the combined assessed level of inherent and control risk is low, (2) a large number of small balances is involved, and (3) the auditor has no reason to believe that the recipients of the request are unlikely to give them consideration.
.11 Notes Receivable

[Prepared on Client’s Letterhead]

[Date]

[Name]

[Address]

Our auditors [name and address of auditors] are performing an audit of our financial statements. Accordingly, please confirm directly to our auditors the amount of your indebtedness due us as of [date], which our records show as follows:

- Type of indebtedness
- Initial date of indebtedness
- Original amount of indebtedness
- Unpaid principal
- Interest rate
- Interest paid to
- Periodic payments required
- Description of collateral

If the above information is in agreement with your records, please so indicate by signing in the following space provided and then return the copy of this letter directly to our auditors in the enclosed envelope.

If the above is not in agreement with your records, please so note in the following space provided the particulars shown in your records along with any information that may help reconcile the difference from our records. Payments should not be sent to the auditors.

Sincerely,

[Client’s Authorized Signature]

The above information is correct as of [date] with the following exceptions (if any):


Signed: ___________________________ Date: ___________________________
.12 Inventories Held byWarehouses or Others When Listing Is Not Provided by Client

[Prepared on Client’s Letterhead]

[Date]

[Name of Warehouse]

[Address]

Our auditors [name and address of auditors] are conducting an audit of our financial statements. Accordingly, please send directly to our auditors the following information about merchandise held in your custody for our account as of [date]:

1. Quantities on hand. For each lot, please indicate the following:
   a. Lot number (list each lot separately)
   b. Date received
   c. Kind of merchandise
   d. Unit of measure or package
      (1) Number of units
      (2) Kind of units (box, can, crate, quart, pound, dozen, or other unit)

2. A statement about how you determined the above requested quantities; specify whether they were determined by physical count, weight, or measure or if they represent your book record

3. A list of negotiable or nonnegotiable warehouse receipts issued (if any) and whether or not such receipts have, to your knowledge, been assigned or pledged.

4. A statement of any known liens against this merchandise.

5. The amount of unpaid charges, if any, as of [date].

Please mail your reply directly to the auditors. A stamped, addressed envelope is enclosed for your convenience.

Sincerely,

[Client’s Authorized Signature]
.13 Inventories Held by Warehouses or Others When Listing Is Provided by Client

[Prepared on Client’s Letterhead]

[Date]

[Name of Warehouse]

[Address]

Our auditors [name and address of auditors] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information about the merchandise held by you for our account as of [date]:

1. The correctness of the quantities shown on the enclosed listing of such merchandise prepared from our records (a second copy is enclosed for your files). If the enclosed listing differs from the quantities you held for us as of [date], please include details of the specific differences in your response to our auditors.

2. Your statement on how you determined the correctness of the quantities you are confirming; please specify whether it was determined by physical count, weight or measure, or whether the quantities are from your records.

3. A list of negotiable or nonnegotiable warehouse receipts issued, if any, and whether or not such receipts have, to your knowledge, been assigned or pledged.

4. A statement of any known liens against these goods.

5. The amount of any unpaid charges as of [date].

Please mail your reply directly to [name and address of auditors]. A stamped, addressed envelope is enclosed for your convenience.

Sincerely,

[Client's Authorized Signature]
.14 Standard Confirmation Inquiry for Life Insurance Policies

LIFE INSURANCE STANDARD CONFIRMATION INQUIRY

RETURN TO: [ ] Date: [ ]

[ ]

REPORT FROM INSURANCE COMPANY [ ]

[ ]

Your completion of the following report will be sincerely appreciated. IF THE ANSWER TO ANY ITEM IS "NONE," PLEASE SO STATE. Use the enclosed envelope to return the original directly to our accountant (see name to left).

Yours truly,

[ ]

(Name of owner as shown on policy contract)

By [ ]

Authorized Signature

Information requested as of: [ ] (Date)

Policy #1 Policy #2 Policy #3

A. Policy Number
B. Insured-Name(s)
C. Beneficiaries as Shown on Policies
   (If Verification Requested in Item 11)

1 Face Amount of Basic Policy
2 Values Shown as of (Insert Date If Other Than Date Requested)
3 Premiums, Including Prepaid Premiums, Are Paid to (Insert Date)
4 Policy Surrender Value (Excluding Dividends, Additions & Indebtedness Adjustments)
5 Surrender Value of All Dividend Credits, Including Accumulations & Additions
6 Termination Dividend Currently Available on Surrender
7 Other Surrender Values Available to Policy Owner
   a. Prepaid Premium Value
   b. Premium Deposit Funds
   c. Other
8 Outstanding Policy Loans, Excluding Accrued Interest
9 If Any Policy Loans Exist, Complete Either "a" or "b"
   a. Interest Accrued on Loans
   b1. Loan Interest is Paid to (Enter Date)
   b2. Interest Rate is (Enter Rate)

NOTE: PLEASE ANSWER ANY ITEM(s) 10–12 INDICATED BY A (√).

☐ 10 Is There an Assignee of Record? (Enter Yes or No)
☐ 11 Is Beneficiary of Record as Shown in Item C. Above? (Enter Yes or No*)
☐ 12 Is the Name of Policy Owner (Subject to Any Assignment) as Shown on Top of Form: ☐ Yes ☐ No
   If No, Enter Name of Policy Owner of Record:

* If Answer to Item 11 is "No." Please Give Name of Beneficiary or Date of Last Beneficiary Change:

Yours truly, (Insurance Company)

ORIGINAL To be mailed to accountant

Date Authorized Signature - Title

Developed by American Institute of Certified Public Accountants Life Office Management Association and Million Dollar Round Table

AICPA Audit and Accounting Manual

AAM §7200.14
**LIFE INSURANCE STANDARD CONFIRMATION INQUIRY**

Return TO: [ ]

Report FROM [ ] Insurance Company [ ]

Date: [ ]

Your completion of the following report will be sincerely appreciated. If the answer to any item is "none," please so state. Use the enclosed envelope to return the original directly to our accountant (see name to left).

Yours truly,

(Name of owner as shown on policy contract)

By ____________________________

Authorized Signature

Information requested as of: ____________________________ (Date)

<table>
<thead>
<tr>
<th>Policy #1</th>
<th>Policy #2</th>
<th>Policy #3</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Policy Number</td>
<td>B. Insured-Name(s)</td>
<td>C. Beneficiaries as Shown on Policies (If Verification Requested in Item 11)</td>
</tr>
</tbody>
</table>

1 Face Amount of Basic Policy

2 Values Shown as of (Insert Date If Other Than Date Requested)

3 Premiums, Including Prepaid Premiums, Are Paid to (Insert Date)

4 Policy Surrender Value (Excluding Dividends, Additions & Indebtedness Adjustments)

5 Surrender Value of All Dividend Credits, Including Accumulations & Additions

6 Termination Dividend Currently Available on Surrender

7 Other Surrender Values Available to Policy Owner
   a. Prepaid Premium Value
   b. Premium Deposit Funds
   c. Other

8 Outstanding Policy Loans, Excluding Accrued Interest

9 If Any Policy Loans Exist, Complete Either "a" or "b"
   a. Interest Accrued on Loans
   b. Loan Interest is Paid to (Enter Date)
   b. Interest Rate is (Enter Rate)

NOTE: PLEASE ANSWER ANY ITEM(s) 10–12 INDICATED BY A (✓).

☐ 10 Is there an assignee of record? (Enter Yes or No)

☐ 11 Is beneficiary of record as shown in Item C, above? (Enter Yes or No*)

☐ 12 Is the name of policy owner (subject to any assignment) as shown on top of form? ☐ Yes ☐ No

* If answer to Item 11 is "No," please give name of beneficiary or date of last beneficiary change: Yours truly, (insurance company)

Authorized Signature - Title

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AAM §7200.14

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.15 Pension Plan Actuarial Information

Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 715, Compensation—Retirement Benefits, provides reduced disclosure requirements for nonissuers. Part C of this letter assumes companies have elected the reduced disclosures allowed by that statement. FASB ASC 715-20-50-5 describes the reduced disclosure requirements. For companies not electing the reduced disclosures, information required for disclosure can be obtained from Parts B and D of the letter.

[Prepared on Client’s Letterhead]

[Name of Actuary]

[Address]

In connection with the audit of our financial statements for the period ending [balance sheet date] by our independent auditors [name and address of auditors], please furnish them the information described as follows as it pertains to the XYZ Pension Plan, which is a defined benefit plan. For your convenience and in response to those requests, you may supply pertinent sections, properly signed and dated, of your actuarial or pension expense report if they are available and if they contain the requested information.

A. Please provide a brief description of the following:

1. The employee group covered.

2. The benefit provisions of the plan used in the calculation of the net periodic pension cost for the period and of the accumulated benefit obligation and the projected benefit obligation at the end of the period. Please identify any such benefit provisions that had not taken effect in the year. Please also provide the date of the most recent plan amendment included in your calculation. Please identify any participants or benefits excluded from the calculations, such as benefits guaranteed under an insurance or annuity contract.

3. The percentages of the plan’s assets that are invested in debt securities, equity securities, real estate, and any additional classifications of investment. Please identify the target compositions, if any, for the aforementioned classifications of investment groups.

4. A narrative description of the plan’s investment policies and strategies, and the basis used to determine the expected long term rate of return on plan assets.

5. The method and the amortization period, if any, used for the following:
   a. Calculation of a market related value of plan assets, if different from the fair value
   b. Amortization of any transition asset or obligation
   c. Amortization of unrecognized prior service cost
   d. Amortization of unrecognized net gain or loss

6. Any substantive commitments for benefits that exceed the benefits defined by the written plan that are included in the calculations.

7. Determination of the value of any insurance or annuity contracts included in the assets.

8. Nature and effect of significant plan amendments and other significant matters affecting comparability of net periodic pension cost, funded status, and other information for the current period with that for the prior period.

9. The following information relating to the employee census data used in calculating the benefit obligations and pension cost:
a. The source and nature of the data is ___________________ and the date as of which the census data was collected is ___________________.

b. The following information concerning participants:

<table>
<thead>
<tr>
<th>Participants</th>
<th>Number of Persons</th>
<th>Compensation (if applicable)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Currently receiving payments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Active with vested benefits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Terminated with deferred vested benefits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Active without vested benefits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other (describe)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: If information is not available for all the above categories, please indicate the categories that have been grouped and describe any group or groups of participants excluded from the above information.

c. Information for the following individuals contained in the census:

<table>
<thead>
<tr>
<th>Participant’s Name or Number</th>
<th>Age or Birth Date</th>
<th>Sex</th>
<th>Salary</th>
<th>Date Hired or Years of Service</th>
</tr>
</thead>
</table>

Note to Auditor: The auditor may select information from employer records to compare with the census data used by the actuary. In addition, the auditor may wish to have the actuary select certain census data from his or her files to compare with the employer’s records.

B. Please provide the following information on the net periodic pension cost for the period ending on __________:

1. Service cost $ ________
2. Interest cost $ ________
3. Expected return on assets $ ________
4. Other components $ ________
   a. Amortization of unrecognized net loss or (gain) from earlier periods $ ________
   b. Amortization of unrecognized prior service cost $ ________
   c. Amortization of the remaining unrecognized net obligation or (asset) existing at the date of the initial application of Financial Accounting Standards Board Accounting Standards Codification 715, Compensation—Retirement Benefits—transition obligation or (asset) $ ________
   d. Amount of loss (or gain) recognized due to a settlement or curtailment $ ________
   e. Net total of components (a+b+c+d) $ ________
5. Net periodic pension cost: (1+2-3+4e) $ ________
6. The above measurement of the net periodic pension cost is based on the following assumptions: Weighted average discount rate ________ %
Weighted average rate of compensation increase ________ %
Weighted average expected long term rate of return on plan assets ________ %

Please describe the basis on which the above rates were selected and whether the basis is consistent with the prior period.
Please briefly describe the other assumptions used in the above measurement.

7. The calculations of the items shown in B1 and B5 are based on the following:
   Asset information ________
   Census data ________
   Measurement date (must not be more than three months before the end of the last fiscal year) ________

Please describe any adjustments made to project the census data forward to the measurement date or to project the results calculated at an earlier date to those shown in B1–B5.

C. Please provide the following information for disclosure in the financial statements for the period ending __________:

   1. Projected benefit obligation $ ________
   2. Fair value of plan assets ________
   3. Funded status of the plan (2-1) ________
   4. Employer contributions to the plan ________
   5. Participant contributions to the plan ________
   6. Benefits paid ________
   7. (Accrued) or prepaid pension cost in the company financial statements ________
   8. The amount of any intangible asset or liability that is recognized may result in a temporary difference, as defined by Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 740, Accounting for Income Taxes. The deferred tax effects of any temporary differences shall be recognized in income tax expense or benefit for the year and shall be allocated to various financial statement components, including other comprehensive income, pursuant to FASB ASC 740.
   9. The amount of any accumulated other comprehensive income or liability that is recognized may result in a temporary difference, as defined by FASB ASC 740. The deferred tax effects of any temporary differences shall be recognized in income tax expense or benefit for the year and shall be allocated to various financial statement components, including other comprehensive income, pursuant to FASB ASC 740.
   10. The amount included in other comprehensive income for the period arising from a change in the minimum pension liability recognized in accordance with FASB ASC 715, Compensation—Retirement Benefits.
   11. The above amount of the projected benefit obligation is measured based on the following assumptions:
       Weighted average discount rate ________ %
       Weighted average rate of compensation increase ________ %

Please provide a brief description of the other assumptions used in the measurement.
12. The calculation of the items shown in C1–C10 is based on the following:
   Asset information
   Census data
   Measurement date (must be not more than three months before the current fiscal year end)
   Please describe any adjustments made to project the census data forward to the measurement date or to project the results calculated at an earlier date to those shown in C1–C10.

13. Please describe any significant events noted subsequent to the current year’s measurement date and as of the date of your reply to this request and the effects of those events, such as a large plant closing, which could materially affect the amounts shown in C1–C10.

14. Please describe any significant transactions between the employer or related parties and the plan during the period, including, if applicable, the amounts and types of securities of the employer and related parties included in plan assets and the amount of future annual benefits covered by insurance contracts issued by the employer or related parties.

D. Please provide an analysis for the period showing beginning amounts, additions, reductions, and ending amounts of the
   1. projected benefit obligation,
   2. fair value of plan assets,
   3. unrecognized prior service cost,
   4. unrecognized net loss (gain),
   5. net transition obligation (asset), and
   6. accumulated benefit obligation (ending amount only).

E. Please provide our independent auditors with descriptions and the amounts of gains or losses from combinations, divestitures, settlements, curtailments or termination benefits during the year, such as
   1. purchases of annuity contracts,
   2. lump sum cash payments to plan participants,
   3. other irrevocable actions that relieved the company or the plan of primary responsibility for a pension obligation and eliminated significant risks related to the obligation and assets,
   4. any events that significantly reduced the expected years of future service of employees,
   5. any events that eliminated for a significant number of employees the accrual of defined benefits for some or all of their future service, or
   6. any special or contractual termination benefits offered to employees.

F. Please provide the amounts of anticipated cash payments for benefits for each of the next 5 years, as well as the expected aggregate amount of benefit payments for the subsequent 5 year period (years 6–10).


H. Describe the nature of your relationship, if any, with the plan or the plan sponsor that may impair or appear to impair the objectivity of your work.
Please mail your response directly to [audit firm’s name and address] in the enclosed return envelope as soon as possible, but no later than [date].

Sincerely,
[Client’s Authorized Signature]

.16 Pension Plan Assets Held by Trustee

[Prepared on Client’s Letterhead]

[Date]

[Name of Trustee or Custodian]

[Address]

Our auditors [name and address of auditor] are conducting an audit of our financial statements. Accordingly, please provide our auditors directly with a listing of the assets including market values as of [date] for our employees’ pension trust [title and trustee’s account number].

Please also provide the auditors with the following information about our employees’ pension trust for the period from [beginning of period] to [end of period]:

1. Contributions by the Company during the above period
2. Contributions by employees during the above period
3. Payments to beneficiaries during the above period
4. Any unpaid fees due for services rendered to [balance sheet date]

Please send your reply directly to our auditors. A stamped, addressed envelope is enclosed for your convenience.

Sincerely,
[Client’s Authorized Signature]

---

4 A listing of the assets might not be requested if one had already been received by the client. In that case, the auditor might want the trustee to confirm the total market value per the listing.
.17 Notes Payable

[Prepared on Client’s Letterhead]

[Date]

[Name]

[Address]

Our auditors [name and address of auditors] are conducting an audit of our financial statements.

Accordingly, please confirm directly to them the following information relating to our note(s) payable to you, as of [date]:

Date of note ________
Original amount $ ________
Unpaid principal
   Balance $ ________
   Periodic payments required $ ________
   Payment periods ________
Maturity date ________ %
Interest rate ________
Date to which interest has been paid ________
Amount and description of collateral ________
Description of terms (for example, demand provisions and prepayment penalties) ________
Any other direct or contingent liabilities to you (please write “None” or provide description) ________

If the above information is in agreement with your records at that date, please so indicate by signing in the following space provided and return the copy of this letter directly to our auditors in the enclosed envelope.

If the above is not in agreement with your records, please note in the following space provided the particulars shown in your records and any information that may help reconcile the difference from our records.

Sincerely,

[Client’s Authorized Signature]

The above information is correct as of [date] with the following exceptions (if any):

Date: __________________________________________ Signature: __________________________________________
Title: __________________________________________
.18 Mortgage Debt

[Prepared on Client’s Letterhead]

[Date]

[Name of Creditor or Trustee]

[Address]

Our auditors [name and address of auditors] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information about our mortgage indebtedness to you as of [date]:

1. Original amount $ __________
2. Date of note __________
3. Unpaid principal balance $ __________
4. Interest rate __________ %
5. Terms for payment of principal __________
6. Date to which interest has been paid __________
7. Nature of mortgage and description or address of property mortgaged __________
8. Amounts on deposit with you in escrow for
   a. insurance $ __________
   b. real estate taxes $ __________
9. Amounts paid during the period [dates from and to] for
   a. insurance $ __________
   b. taxes $ __________
10. Amounts on deposit with you for the reserve for repairs $ __________
11. The nature of defaults, if any __________
12. Description of terms (for example, prepayment penalties and demand provisions) __________

A return envelope is enclosed for your reply.

Sincerely,

[Client’s Authorized Signature]

---

Note:

Many of the items requested will vary with the circumstance of the particular mortgage or other debt involved. The above sample assumes the indenture involves an escrow arrangement for insurance and real estate taxes and a deposit account for repairs.
.19 Accounts Payable

[Prepared on Client’s Letterhead]

[Date]

[Name]

[Address]

In connection with the audit of our financial statements, please confirm directly to our auditors [name and address of auditors], the amount of our liability to you as of [date]. Please attach a statement of our account due. If no balance is due, please attach a statement of our account showing payments made.

Please mail your reply directly to [name of auditors]. A stamped, addressed envelope is enclosed for your convenience.

Sincerely,

[Client’s Authorized Signature]

________________________________________

Our records indicate that a balance of $_______ was from [name of client] at [date].

Date: ____________________________ Signature: ____________________________

Title: ____________________________
.20 Obligation to Lessor

[Prepared on Client’s Letterhead]

[Date]

[Name of Lessor]

[Address]

Our auditors [name and address of auditors] are conducting an audit of our financial statements as of [balance sheet date] and for the [time period] then ended. In connection with this audit, please provide directly to our auditors the following information as of [balance sheet date] regarding the lease dated [date lease was executed] of [brief identification of property under lease] that we are leasing from you:

1. Inception and expiration dates for the lease period, from __________ to __________
2. Amount of monthly rent ________________
3. Renewal options (if any):
   a. Dates of renewal period, from __________ to __________
   b. Amount of monthly rent for renewal ________________
4. Purchase options (if any):
   a. Amount of purchase price __________
   b. Inception and expiration dates of option, from __________ to __________
   c. Percent of monthly rent (if any) applicable towards purchase price __________
5. Dates and descriptions of amendments or supplementary understandings, if any, to the lease mentioned above.
6. The amount of outstanding delinquent payments, if any
7. A statement that there are no defaults or a statement of the nature of defaults, if any

A return envelope is enclosed for your reply.

Sincerely,

[Client’s Authorized Signature]

Note: The content of this type of letter will vary based on the auditor’s professional judgment in the circumstances. To provide additional illustrative language, the above letter is not made parallel with the illustration at AAM section 7200 paragraph .23.
.21 Property Out on Lease

[Prepared on Client’s Letterhead]

[Date]

[Name of Lessee]

[Address]

Our auditors [name and address of auditors] are conducting an audit of our financial statements as of [balance sheet date] and for the [time period] then ended. In connection with this audit, please confirm directly to our auditors the following information regarding the lease dated [execution date of lease] of [brief identification of property under lease] that you are leasing from us:

1. Inception and expiration dates of lease period from ____________ to ______________
2. Amount of monthly rent ________________
3. Total rent payments made ________________
4. Date of last payment ________________

A return envelope is enclosed for your reply.

Sincerely,

[Client’s Authorized Signature]

Notes:

(A) If the leased property is of a mobile or portable nature such as a bulldozer or television camera, the confirmation may also include a request for specific serial numbers of significant equipment.

(B) In certain circumstances, the auditor may wish to consider confirming additional information such as renewal options, purchase options, and amendments or supplementary understandings.
Register—Capital Stock

[Prepared on Client’s Letterhead]

[Date]

[Name of Registrar]

[Address]

Our auditors [name and address of auditors] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information as of the close of business [balance sheet date] about each class of our preferred and common stock:

1. Authorized number of shares ____________________
2. Issued number of shares _______________________
3. Outstanding number of shares ___________________

Please also indicate the amount of any unpaid registrar fees due you as of [balance sheet date].

A return envelope is enclosed for your convenience.

Sincerely,

[Client’s Authorized Signature]

The above information agrees with our records at [balance sheet date] with the following

________________________
________________________
________________________

Signed: __________________ Date: __________________________

[Name and Title]

Notes:

(A) It may be helpful to include the registrar’s account number for the client’s account to receive a timely response.

(B) Some auditors prefer that the confirmation request include identification of each class of stock.

(C) The above illustration assumes the client has a separate transfer agent (see AAM section 7200 paragraph .25).
Transfer Agent—Capital Stock

[Prepared on Client’s Letterhead]

[Date]

[Name of Transfer Agent]

[Address]

Our auditors [name and address of auditors] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information as of [balance sheet date] about each class of our preferred and common stock:

1. Authorized number of shares __________________________

2. Number of shares issued and outstanding __________________________

3. Number of outstanding shares registered in the name of our Company ________________________

Please also indicate the amount of any unpaid transfer agent fees due you as of [balance sheet date].

A return envelope is enclosed for your convenience.

Sincerely,

[Client’s Authorized Signature]

The above information agrees with our records at [balance sheet date] with the following exceptions:

<table>
<thead>
<tr>
<th>Date: __________________________</th>
</tr>
</thead>
<tbody>
<tr>
<td>Name and Title: _______________</td>
</tr>
</tbody>
</table>

Notes:

(A) It may be helpful to include the transfer agent’s account number for the client’s account to receive a timely response.

(B) Some auditors prefer that the confirmation request include identification of each class of stock.

(C) Depending on the auditor’s judgment in the circumstances the confirmation request may also include inquiries about such matters as (1) the number of shares issued to each of specifically mentioned officers and directors, (2) specified information about shareholders owning more than a stated percent of the total outstanding shares, and (3) amounts deposited during the year for the payment of dividends.
.24 Request for Confirmation of Money Market Fund

[Prepared on Client’s Letterhead]

[Date]

[Name]

[Address]

Our auditors [name and address of auditors] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the balance of our money market fund account(s) as of [date].

Please indicate in the following space provided the account number(s) and balance(s) of our account(s) per your records.

Please sign and date your reply and return it directly to the auditors. A stamped, self-addressed envelope is enclosed for your convenience.

Sincerely,

[Client’s Authorized Signature]

________________________________________

<table>
<thead>
<tr>
<th>Account No.</th>
<th>Date</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Date:____________________________ Signed:____________________________
.25 Confirmation of Contingent Liabilities

[Date]

Financial Institution Official

First United Bank
Anytown, USA 00000

In connection with an audit of the financial statements of [name of customer] as of [balance sheet date] and for the [period] then ended, we have advised our independent auditors of the following listed information, which we believe is a complete and accurate description of our contingent liabilities, including oral and written guarantees, with your financial institution. Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other contingent liabilities, including oral and written guarantees, from your financial institution comes to your attention, please include such information in the following space provided.

<table>
<thead>
<tr>
<th>Name of Maker</th>
<th>Date of Note</th>
<th>Due Date</th>
<th>Current Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Interest Rate</th>
<th>Date Through Which Interest is Paid</th>
<th>Description of Collateral</th>
<th>Description of Purpose of Note</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Information related to oral and written guarantees is as follows:

__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________

Please confirm whether the information about contingent liabilities presented above is correct by providing a signature below and returning this directly to our independent auditors [name and address of CPA firm].

Sincerely,

[Name of Customer]

________________________________________
By: _____________________________________

[Authorized Signature]

* This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the transactions or arrangements. Some official institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function. Independent auditors should ascertain the appropriate recipient.
Dear CPA Firm:

The above information listing contingent liabilities, including oral and written guarantees, agrees with the records of this financial institution.† Although we have not conducted a comprehensive, detailed search of our records, no information about other contingent liabilities, including oral and written guarantees, came to our attention. (Note exceptions below or in an attached letter.)

[Name of Financial Institution]

By: _______________________________ _________________

[Officer] _________________________________

[Title] [Date]

† If applicable, comments similar to the following may be added to the confirmation reply by the financial institution: This confirmation does not relate to arrangements, if any, with other branches or affiliates of this financial institution. Information should be sought separately from such branches or affiliates with which any such arrangements might exist.
.26 Confirmation of Compensating Balances

[Date]

Financial Institution Official

First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of [name of customer] as of [balance sheet date] and for the [period] then ended, we have advised our independent auditors that as of the close of business on [balance sheet date] there (were) (were not) compensating balance arrangements as described in our agreement dated [date]. Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other compensating balance arrangements between [name of customer] and your financial institution comes to your attention, please include such information below. Withdrawal by [name of customer] of the compensating balance (was) (was not) legally restricted at [date]. The terms of the compensating arrangements at [date] were:

EXAMPLES:

1. The Company has been expected to maintain an average compensating balance of 20 percent of its average loan understanding, as determined from the financial institution’s ledger records adjusted for estimated average uncollected funds.
2. The Company has been expected to maintain an average compensating balance of $100,000 during the year, as determined from the financial institution’s ledger records without adjustment for uncollected funds.
3. The Company has been expected to maintain a compensating balance, as determined from the financial institution’s ledger records without adjustment for uncollected funds, of 15 percent of its outstanding loans plus 10 percent of its unused line of credit.
4. The Company has been expected to maintain as a compensating balance noninterest bearing time deposits of 10 percent of its outstanding loans.

In determining compliance with compensating balance arrangements, the Company uses a factor for uncollected funds of _____ [business calendar] days.\(^5\)

There (were the following) (were no) changes in the compensating balance arrangements during the [period] and subsequently through the date of this letter.

The Company (was) (was not) in compliance with the compensating balance arrangements during the [period] and subsequently through the date of this letter.

There (were the following) (were no) sanctions (applied or imminent) by the financial institution because of noncompliance with compensating balance arrangements.\(^6\)

During the [period], and subsequently through the date of this letter, (no) (the following) compensating balances were maintained by the Company at the financial institution on behalf of an affiliate, director, officer, or any other third party, and (no) (the following) third party maintained compensating balances at the bank on behalf of the Company. (Withdrawal of such compensating balances (was) (was not) legally restricted.)

\(\text{\footnotesize \text{\textsuperscript{1}} This letter should be addressed to a financial institution official who is responsible for the financial institution’s relationship with the client or is knowledgeable about the compensating balance arrangements. Some financial institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function. Independent auditors should ascertain the appropriate recipient.}\)

\(\text{\footnotesize \text{\textsuperscript{5}} This is not applicable if compensating balances are based on the financial institution’s ledger records without adjustment for uncollected funds. If some other method is used for determining collected funds for compensating balance purposes, the method used should be described.}\)

\(\text{\footnotesize \text{\textsuperscript{6}} This is applicable only if the financial institution has applied sanctions during the [period] or notified the Company that sanctions may be applied. Indicate details.}\)
Please confirm whether the information about compensating balances presented above is correct by signing in the following space provided and returning this letter directly to our independent auditors [name and address of CPA Firm].

Sincerely,

[Name of Customer]

________________________________________

By: _____________________________________

[Authorized Signature]

Dear CPA Firm:

The above information regarding the compensating balance arrangements with this financial institution agrees with the records of this financial institution. Although we have not conducted a comprehensive, detailed search of our records, no information about other compensating balance arrangements, came to our attention. (Note exceptions in the following space provided or in an attached letter.)

__________________________________________________

[Name of Financial Institution]

By: _______________________________ _________________

[Officer] [Date]

[Title]
.27 Confirmation of Lines of Credit

[Date]

Financial Institution Official

First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of [name of client] as of [balance sheet date] and for the [period] then ended, we have advised our independent auditors of the following information that we believe is a complete and accurate description of our line of credit from your financial institution as of the close of business on [balance sheet date]. Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other lines of credit from your financial institution comes to your attention, please include such information in the following space provided.

The Company has available at the financial institution a line of credit totaling $[amount]. The current terms of the line of credit are contained in the letter dated [date]. The related debt outstanding at the close of business on [date] was $[amount].

The amount of unused line of credit, subject to the terms of the related letter, at [date] was $[amount].

Interest rate at the close of business on [date] was _____ percent.

Compensating balance arrangements are:

____________________________________________________________________

____________________________________________________________________

____________________________________________________________________

This line of credit supports commercial paper (or other borrowing arrangements) as described in the following space provided:

____________________________________________________________________

____________________________________________________________________

____________________________________________________________________

Please confirm whether the information about lines of credit presented above is correct by signing in the following space provided and returning this letter directly to our independent auditors [name and address of CPA Firm].

Sincerely,

[Name of Client]

________________________________________

By: _____________________________________

[Authorized Signature]

11 This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the lines of credit. Some financial institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function. Independent auditors should ascertain the appropriate recipient.
Dear CPA Firm:

The above information regarding the line of credit arrangements agrees with the records of this financial institution. Although we have not conducted a comprehensive, detailed search of our records, no information about other lines of credit came to our attention. (Note exceptions in the following space provided or in an attached letter.)

[Name of Financial Institution]

By: ________________________________

[Officer] ____________________________ [Date] __________

[Title] ____________________________
.28 Related Party Confirmation

In certain situations, the auditor may want to confirm the existence of related parties with directors, principal officers, major shareholders, or others. For example, a company does not have adequate controls and processes in place to identify related party transactions and the auditor has not otherwise been satisfied as to the extent of related party transactions. The following is an illustrative related party confirmation letter that an auditor may use when the auditor is not otherwise satisfied as to the extent of related party transactions.

[Date]

[Name of Director, Principal Officer, or Major Stockholder]

[Address]

Dear [Name]:

In connection with an audit of our financial statements, please furnish answers to the attached questionnaire, sign your name, and return the questionnaire in the enclosed stamped, addressed envelope directly to our auditors [name and address of auditors]. The questionnaire is designed to provide the auditors with information about the interests of officers, directors, and other related parties in transactions with the Company.

Please answer all questions. If the answer to any question is “yes,” please explain why it is so. Certain terms used in the questions are defined at the end of the questionnaire. Please read the definitions carefully before answering the questions. Thank you for your cooperation.

Sincerely,

[Client’s Authorized Signature]

[Title]
Related Party Questionnaire

Please answer all questions. If the answer to any question is “yes,” please explain why it is so. Certain terms used in the questions are defined at the end of the questionnaire. Please read the definitions carefully before answering the questions.

1. Have you or any related party of yours had any interest, direct or indirect, in any sales, purchases, transfers, leasing arrangements, guarantees, or other transactions since [beginning of period of audit] to which the Company (or specify any pension, retirement, savings, or similar plan provided by the client) was, or is to be, a party?

2. Do you or any related party of yours have any interest, direct or indirect, in any pending or incomplete sales, purchases, transfers, leasing arrangements, guarantees or other transactions to which the Company (or specify any pension, retirement, savings, or similar plan provided by the client) is, or is to be, a party?

3. Have you or any related party of yours been indebted to the Company (or specify any pension, retirement, savings, or similar plan provided by the client) at any time since [beginning of period of audit]? Please exclude amounts due for purchases on usual trade terms and for ordinary travel and expense advances.

The answers to the foregoing questions are correct to the best of my knowledge and belief.

[Signature] [Date]

Definitions

**company.** Parent company, any subsidiary or investee for which investments are accounted for by the equity method

**related party.** Any (1) party (other than the Company) of which you are an officer, director, or partner or are, directly or indirectly, the beneficial owner of 10 percent or more of the voting interests; (2) any trust or other estate in which you have a substantial beneficial ownership or for which you serve as a trustee or in a similar fiduciary capacity; (3) any member of your immediate family; and (4) other party with which you may deal if you (or the other party) control or can significantly influence the other to an extent that either of you might be prevented from fully pursuing your own separate interests.

**control.** Possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a party, whether through ownership, by contract, or otherwise.

**party.** An individual, a corporation, a partnership, an association, a joint stock company, a business trust, or an unincorporated organization.

**beneficial owner.** Party who enjoys, or has the right to secure, benefits substantially equivalent to those of the ownership of securities, even though the securities are not registered in the party’s name. Examples of beneficial ownership include securities held for the party’s benefit in the name of others, such as nominees, custodians, brokers, trustees, executors and other fiduciaries; a partnership of which the person is a partner; and a corporation for which the party owns substantially all of the stock. Shares (1) held (individually or in a fiduciary capacity) by the party’s spouse, the party’s or his or her spouse’s minor children, or a relative of the party or his or her spouse who shares the same home with the party; or (2) as to which the party can vest or revest title in himself or herself at once or at some future time are also considered as being beneficially owned.
.29 Safe Deposit Box Access Confirmation

[Date]

[Name]

[Address]

Our auditors [name and address of auditors], are conducting an audit of our financial statements. Accordingly, please confirm there has been no access to our safe deposit box number _____ between _____ and _____ o’clock.

Please indicate in the following space provided if the previous statement is in agreement with your records. If it is not, please furnish the auditors any details concerning access to our safe deposit box during the period indicated.

After signing and dating your reply, please mail it directly to our auditors in the enclosed envelope.

Sincerely,

[Client’s Authorized Signature]

According to our records, there has been no access to the above described safe deposit box during the period specified, except as follows:

________________________________________________________________________

________________________________________________________________________

Signed: ___________________ Date: ___________________

[Name and Title]
.30 Insurance In Force Confirmation Request

[Date]

[Name]

[Address]

Our auditors, [name and address of auditors], are conducting an audit of our financial statements. In that connection, please confirm the details of our insurance coverage in force at ____________________ [balance sheet date] as described in the following space provided:

Policy number ____________ ____________
Insurance company ____________ ____________
Type of coverage ____________ ____________
Amount of coverage ____________ ____________
Co-insurance, if any ____________ ____________
Term of policy ____________ ____________
Gross premium ____________ ____________
Amount of unpaid premiums ____________ ____________
Loss payees, if other than us ____________ ____________
Claims pending at ___________________________ [date] ____________ ____________

Please compare this information with your records and inform our auditors, in the following space, if it is or is not in agreement with your records. After signing and dating your reply, please mail it directly to our auditors in the enclosed envelope.

Sincerely,

[Client’s Authorized Signature]

The above information agrees with our records at ____________ [balance sheet date] with the following exceptions:

________________________________________________________________________
________________________________________________________________________
________________________________________________________________________

Signed: ______________________________________ Date: __________________________

[Name and Title]

[The next page is 7301.]
AAM Section 7300

Inquiries to Legal Counsel

.01 Illustrative Audit Inquiry Letter to Legal Counsel

[Prepared on Client’s Letterhead]

[Date]

[Name of Lawyer]

[Address of Lawyer]

Dear [Name]: In connection with an audit of our financial statements at (balance sheet date) and for the (period) then ended, management of the Company has prepared, and furnished to our auditors (name and address of auditors), a description and evaluation of certain contingencies, including those set forth below involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. These contingencies are regarded by management of the Company as material for this purpose (management may indicate a materiality limit if an understanding has been reached with the auditor). Your response should include matters that existed at (balance sheet date) and during the period from that date to the date of your response.

Pending or Threatened Litigation (excluding unasserted claims)

[Ordinarily the information would include the following: (1) the nature of the litigation, (2) the progress of the case to date, (3) how management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.] Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated and an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

Unasserted Claims and Assessments (considered by management to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome)

[Ordinarily management’s information would include the following: (1) the nature of the matter, (2) how management intends to respond if the claim is asserted, and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.] Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated.

1 If a client has not needed to retain legal counsel, the auditor may express an unqualified opinion on the financial statements even though he or she has not obtained a letter from legal counsel of the Company. In these circumstances, the auditor may consider obtaining written representation from the Company that legal counsel has not been retained for matters concerning business operations that may involve current or prospective litigation. Auditing Interpretation No. 6, “Client Has Not Consulted a Lawyer,” of AU section 337, Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments (AICPA, Professional Standards, vol. 1, AU sec. 337 par. 15–17), provides guidance for auditors when the client has not retained legal counsel during the period under audit.

2 Extracted from AU section 337A, Illustrative Audit Inquiry Letter to Legal Counsel (AICPA, Professional Standards, vol. 1), the appendix to AU section 337. (See footnote 4.)

3 Paragraph .09 of AU section 337 discusses the matters that should be covered in a letter of audit inquiry.

4 Sending of this letter should be timed so that the lawyer’s response is dated as close to the auditor’s opinion date as practical. However, the auditor and client may consider early mailing of a draft inquiry as a convenience for the lawyer in preparing a timely response to the formal inquiry letter.
We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Financial Accounting Standards Board Accounting Standards Codification 450, Contingencies. Please specifically confirm to our auditors that our understanding is correct.

Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the company, such as guarantees of indebtedness of others.]

Sincerely,

[Authorized Signature for Client]
.02 Illustrative Inquiry Letter to Legal Counsel If Management Has Not Provided Details About Pending or Threatened Litigation

[Prepared on Client’s Letterhead]

[Date]

[Name of Lawyer]

[Address of Lawyer]

In connection with an audit of our financial statements at [balance sheet date] and for the [period] then ended, please furnish to our auditors [name and address of auditors] the information requested below for which you have been engaged to provide legal consultation or representation.

Pending or Threatened Litigation, Claims and Assessments

(excluding unasserted claims and assessments)

Please furnish a list of all pending or threatened litigation, claims, and assessments your firm is handling on our behalf including the following:

1. The nature of the litigation (including the amount of monetary or other damages sought)
2. The progress of the case to date
3. How management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement)
4. An evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss

Unasserted Claims and Assessments

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosing concerning such possible claim or assessment, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 450, Contingencies, as a matter of professional responsibility to us. Please specifically confirm to our auditors that our understanding is correct.

We have represented to our auditors that there are no unasserted claims which are not specifically identified in this letter that you advised us are probable of assertion and must be disclosed in accordance with FASB ASC 450.

(If unasserted claims exist, management’s listed information should include the following: (1) the nature of the matter; (2) how management intends to respond if the claim is asserted; and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.)

Please furnish our auditors with any explanation you consider necessary to supplement the foregoing information, including an explanation of these matters as to which your views may differ from those stated.

Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the organization, such as guarantees of indebtedness of others.]

Sincerely,

[Authorized Signature for Client]
Notes:

(A) Paragraph .09 of AU section 337, Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments (AICPA, Professional Standards, vol. 1), discusses the matters that should be covered in a letter of audit inquiry.

(B) The sending of this letter should be timed so that the lawyer’s response is dated as close to the auditor’s opinion date as practicable. However, the auditor and client may consider early mailing of a draft inquiry as a convenience for the lawyer in preparing a timely response to the formal inquiry letter.

(C) If a client has not needed to retain legal counsel, an unqualified opinion may be expressed on the financial statements even though a letter from legal counsel has not been obtained. In these circumstances, the auditor may consider obtaining a written representation from the Company that legal counsel has not been retained for matters concerning its operations that involve current or prospective litigation. Interpretation No. 6, “Client Has Not Consulted a Lawyer,” of AU section 337 (AICPA, Professional Standards, vol. 1, AU sec. 9337 par. .15-.17), provides guidance for auditors when the client has not retained legal counsel during the period under audit.
.03 Improving Inquiry Techniques

If inquiries to legal counsel are not sufficiently detailed or specific, deficiencies in attorneys’ responses may result. A conference between the auditor and the attorney may be necessary to clarify the attorney’s written response, and paragraph .10 of AU section 337 provides for such a conference. However, to improve the auditor’s ability to receive all of the information necessary to complete his or her audit, he or she may consider the following matters in an inquiry to legal counsel:

a. A request that the attorney specify the effective date of his or her response if it is other than the date of the reply.

b. A request that the attorney mail the response so that it will be received by a certain date.

c. A request that the nature of any litigation specifically identify (1) the proceedings, (2) the claim(s) asserted, (3) the amount of monetary damages sought, or if no amounts are indicated in preliminary case filings, a statement to that effect, and (4) the objectives sought by the plaintiff, if any, other than monetary or other damages (such as performance or discontinued performance of certain actions).  
d. A request that the attorney avoid such vague phrases as meritous defenses, without substantial merit, and reasonable chance in expressing an opinion on the outcome of litigation.

e. If an opinion cannot be expressed on the outcome of litigation, a request that the attorney so state together with his or her reasons for that position.

f. A request that the attorney specify to what extent potential damages are covered by insurance. (It may be possible to obtain the opinion of the insurer’s counsel regarding the applicability of insurance coverage.)

g. A request that the attorney provide a summary of material litigation, claims, and assessments settled during the period.

h. A statement that confirmation of the understanding regarding disclosure of unasserted claims and assessments is an integral part of the audit inquiry and that failure to so confirm will require a follow-up contact.

i. A statement that the attorney’s response will not be quoted or referred to in the financial statements without first consulting with him or her.

[The next page is 7401.]
AAM Section 7400

Management Representations and Representation Letters

.01 AU section 333, Management Representations (AICPA, Professional Standards, vol. 1), states that written representations from management should be obtained for all financial statements and periods covered by the auditor’s report. The specific written representations obtained by the auditor will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements.¹

.02 Written representations from management ordinarily confirm representations explicitly or implicitly given to the auditor, indicate and document the continuing appropriateness of such representations, and reduce the possibility of misunderstanding concerning the matters that are the subject of the representations. Such representations from management are part of the audit evidence the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit.

Specific Representations

.03 In connection with an audit of financial statements presented in accordance with generally accepted accounting principles (GAAP), specific representations should relate to the following matters:

Financial Statements

a. Management’s acknowledgment of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with GAAP.

b. Management’s belief that the financial statements are fairly presented in conformity with GAAP.

Completeness of Information

c. Availability of all financial records and related data.

d. Completeness and availability of all minutes of meetings of stockholders, directors, and committees of directors.

e. Communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.

f. Absence of unrecorded transactions.

¹ AICPA Technical Questions and Answers (TIS) section 9100.06, “The Effect of Obtaining the Management Representation Letter on Dating the Auditor’s Report” (AICPA, Technical Practice Aids), provides nonauthoritative guidance for auditors when conducting audits in accordance with generally accepted auditing standards. TIS section 9100.06 discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor’s report. TIS section 9100.06 indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor’s report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.
Recognition, Measurement, and Disclosure

g. Management’s belief that the effects of any uncorrected financial statement misstatements\(^2\) aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.\(^3\) (A summary of such items should be included in or attached to the letter.)\(^4\)

h. Management’s acknowledgement of its responsibility for the design and implementation of programs and controls to prevent and detect fraud.

i. Knowledge of fraud or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements.

j. Knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.

k. Plans or intentions that may affect the carrying value or classification of assets or liabilities.

l. Information concerning related party transactions and amounts receivable from or payable to related parties.

m. Guarantees, whether written or oral, under which the entity is contingently liable.

n. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 275, Risks and Uncertainties.

o. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

p. Unasserted claims or assessments that the entity’s lawyer has advised are probable of assertion and must be disclosed in accordance with FASB ASC 450, Contingencies.\(^5\)

q. Other liabilities and gain or loss contingencies that are required to be accrued or disclosed by FASB ASC 450.

r. Satisfactory title to assets, liens or encumbrances on assets, and assets pledged as collateral.

s. Compliance with aspects of contractual agreements that may affect the financial statements.

Subsequent Events

t. Information concerning subsequent events.

The representation letter ordinarily should be tailored to include additional appropriate representations from management concerning matters specific to the entity’s business or industry.

\(^2\) Paragraph .07 of AU section 312, Audit Risk and Materiality in Conducting an Audit (AICPA, Professional Standards, vol. 1), states that a misstatement can result from errors or fraud and provides guidance for the auditor’s evaluation of audit findings. (See AU section 312 par. .50–.61.)

\(^3\) If management believes that certain identified items are not misstatements, management’s belief may be acknowledged by adding to the representation (for example, “We do not agree that items XX and XX constitute misstatements because [description of reasons]”).

\(^4\) AU section 312 states that the auditor may designate an amount below which misstatements need not be accumulated. Similarly, the summary of uncorrected misstatements included in or attached to the representation letter need not include such misstatements. The summary should include sufficient information to provide management with an understanding of the nature, amount, and effect of the uncorrected misstatements. Similar items may be aggregated.

\(^5\) If the entity has not consulted a lawyer regarding litigation, claims, and assessments, the auditor normally would rely on the review of internally available information and obtain a written representation by management regarding the lack of litigation, claims, and assessments; see Interpretation No. 6, “Client Has Not Consulted a Lawyer” of AU section 337, Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments (AICPA, Professional Standards, vol. 1, AU sec. 9337 par. .15–.17).
Materiality Considerations

.04 Management’s representations may be limited to matters that are considered either individually or collectively material to the financial statements, provided management and the auditor have reached an understanding on materiality for this purpose. Materiality may be different for different representations. A discussion of materiality may be included explicitly in the representation letter, in either qualitative or quantitative terms. Materiality considerations would not apply to those representations that are not directly related to amounts included in the financial statements.

Addressing and Dating

.05 The written representations should be addressed to the auditor. Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to or disclosure in the financial statements, the representations should be made as of the date of the auditor’s report.

Management’s Signatures

.06 The letter should be signed by those members of management with overall responsibility for financial and operating matters whom the auditor believes are responsible for and knowledgeable about, directly or through others in the organization, the matters covered by the representations. Such members of management normally include the chief executive officer and chief financial officer or others with equivalent positions in the entity.

Scope Limitations

.07 Management’s refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause an auditor to disclaim an opinion or withdraw from the engagement. However, based on the nature of the representations not obtained or the circumstances of the refusal, the auditor may conclude that a qualified opinion is appropriate. Further, the auditor should consider the effects of the refusal on his or her ability to rely on other management representations.

Illustrative Representation Letter—Audit of Financial Statements

.08 The following letter, which relates to an audit of financial statements prepared in conformity with GAAP, is presented for illustrative purposes only. The introductory paragraph should specify the financial statements and periods covered by the auditor’s report (for example, “balance sheets of XYZ Company as of December 31, 20X1 and 20X0, and the related statements of income and retained earnings and cash flows for the years then ended”). The written representations to be obtained should be based on the circumstances of the engagement and the nature and basis of presentation of the financial statements being audited.

.09 If matters exist that should be disclosed to the auditor, they should be indicated by modifying the related representation. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, the final paragraph could be modified as follows: “To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred...” In appropriate circumstances, item 9 could be modified as follows: “The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities, except for its plans to dispose of segment A, as disclosed in Note X to the financial statements, which are discussed in the minutes of the December 7, 20X1, meeting of the board of directors.” Similarly, if management has received a communication regarding an allegation of fraud or suspected fraud, item 8 could be modified as follows: “Except for the allocations discussed in the minutes of the December 7, 20X1, meeting of the board of directors (or disclosed to you at our meeting on October 15, 20X1), we have no knowledge of any allegations of fraud or suspected...
fraud affecting the company received in communications from employees, former employees, analysts, regulators, short sellers, or others."

.10 The qualitative discussion of materiality used in the illustrative letter is adapted from FASB Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information.

.11 Certain terms are used in the illustrative letter that are described elsewhere in authoritative literature. Examples are fraud, in AU section 316, Consideration of Fraud in a Financial Statement Audit, (AICPA, Professional Standards, vol. 1), and related parties in footnote 1 of AU section 334, Related Parties (AICPA, Professional Standards, vol. 1). To avoid misunderstanding concerning the meaning of such terms, the auditor may wish to furnish those definitions to management or request that the definitions be included in the written representations.

.12 The illustrative letter assumes that management and the auditor have reached an understanding on the limits of materiality for purposes of the written representations. However, it should be noted that a materiality limit would not apply for certain representations, as explained in paragraph .08 of AU section 333.

.13 Illustrative Representation Letter

[Prepared on Client's Letterhead]

[Date]

To [Independent Auditor]

We are providing this letter in connection with your audit(s) of the [identification of financial statements] of [name of entity] as of [dates] and for the [periods] for the purpose of expressing an opinion as to whether the [consolidated] financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of [name of entity] in conformity with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation in the [consolidated] financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, (as of [date of auditor's report]), the following representations made to you during your audit(s).

1. The financial statements referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America.

2. We have made available to you all—
   a. Financial records and related data.
   b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

3. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.

4. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
5. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

6. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.

7. We have no knowledge of any fraud or suspected fraud affecting the entity involving—
   a. Management,
   b. Employees who have significant roles in internal control, or
   c. Others where the fraud could have a material effect on the financial statements.

8. We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.

9. The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

10. The following have been properly recorded or disclosed in the financial statements:
    a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
    b. Guarantees, whether written or oral, under which the company is contingently liable.
    c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 275, Risks and Uncertainties [Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.]

11. There are no—
    a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
    b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with FASB ASC 450.6
    c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB ASC 450, Contingencies.

12. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.

13. The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

[Add additional representations that are unique to the entity’s business or industry. See paragraph .07 and appendix B, of AU section 333.]

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6 In the circumstances discussed in footnote 7 of AU section 333, Management Representations (AICPA, Professional Standards, vol. 1), this representation might be worded as follows:

We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Financial Accounting Standards Board Accounting Standards Codification 450, Contingencies, and we have not consulted a lawyer concerning litigation, claims, or assessments.
To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

[Name of Chief Executive Officer and Title]

[Name of Chief Financial Officer and Title]

Notes:
Depending on the nature, materiality, and complexity of fair values, management representations about fair value measurements and disclosures contained in the financial statements also may include representations about

- the appropriateness of the measurement methods, including related assumptions used by management in determining the fair value and the consistency in application of the methods;
- the completeness and adequacy of disclosures related to fair values; and
- whether subsequent events require adjustments to the fair value measurements and disclosures are included in the financial statements.

[Source: Paragraph .49 of AU section 328, Auditing Fair Value Measurements and Disclosures (AICPA, Professional Standards, vol. 1)]


.14 Illustrative Representation Letter—Audit of Personal Financial Statements

[Date]

[To the Independent Auditor]

We are providing this letter in connection with your audit of the statement of financial condition of James and Jane Person as of [date] and the related statement of changes in net worth for the [period] then ended for the purpose of expressing an opinion as to whether the financial statements present fairly, in all material respects, the financial condition and changes in the net worth, of James and Jane Person in conformity with generally accepted accounting principles. We confirm that we are responsible for the fair presentation in the statement of financial condition and changes in net worth in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, [as of (date of auditor’s report),] the following representations made to you during your audit.

1. The financial statements referred to above are fairly presented in conformity with generally accepted accounting principles.

2. We have made available to you all financial records and related data.

3. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.

4. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

5. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.

6. We have no knowledge of any fraud or suspected fraud affecting the entity involving
   a. us.
   b. others where the fraud could have a material effect on the financial statements.

7. We have no knowledge of any allegations of fraud or suspected fraud affecting us received in communications from analysts, regulators, short sellers, or others.

8. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

9. The following have been properly recorded or disclosed in the financial statements:
   a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
   b. Guarantees, whether written or oral, under which we are contingently liable.
   c. Significant estimates and material concentrations known to us that are required to be disclosed in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 275, Risks and Uncertainties. (Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.)

10. There are no
    a. violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
    b. unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with FASB ASC 450, Contingencies.
    c. other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB ASC 450.

11. We have satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.

12. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

Footnote 7 of AU section 333 states that if a lawyer has not been consulted regarding litigation, claims, and assessments, the auditor normally would rely on the review of internally available information and obtain a written representation by management regarding the lack of litigation, claims, and assessments. In the circumstances discussed in footnote 7 to AU section 333, this representation might be worded as follows:

  We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Financial Accounting Standards Board Accounting Standards Codification 450, Contingencies, and we have not consulted a lawyer concerning litigation, claims, or assessments.

Interpretation No. 6 of AU section 337 also provides guidance for auditors when the client has not retained legal counsel during the period under audit.
To the best of our knowledge and belief, no events have occurred subsequent to the statement of financial condition date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

_________________________________
(James Person)

_________________________________
(Jane Person)

.15 Illustrative Representation Letter to Other Accountants

[Firm's Letterhead]

[Date]
[Name]
[Address]

In connection with the report you have been requested to reissue on the financial statements of [client’s name] for the year ended [date], which statements are to be included comparatively with similar statements for the year ended [date], we make the following representations.

We have audited (or reviewed or compiled) the balance sheet of [client’s name] as of [balance sheet date] and the related statements of earnings, retained earnings, and cash flows for the year then ended. Our procedures in connection with the engagement did not disclose any events or transactions subsequent to [predecessor’s balance sheet date] which, in our opinion, would have a material effect upon the financial statements, or which would require mention in the notes to the financial statements of [client’s name] for the year then ended.

Should anything come to our attention prior to the date our report is issued that, in our judgment, would have a material effect upon the financial statements covered by your report, we shall notify you promptly.

Sincerely,

[Engagement Partner’s Signature]

Note:
If any matters come to the firm’s attention that may require revision of the previous financial statements, they could be included in a separate paragraph after approval by the engagement partner.

.16 Letter to Other Accountants Upon Whose Work We Plan to Rely

[Firm’s Letterhead]

[Date]
[Name]
[Address]

We are auditing the financial statements of [client’s name], [parent company]. The financial statements of [other accountants’ client’s name] that you are auditing are to be included in the financial statements of [client’s name]. We will rely on your report on the financial statements in expressing an opinion on the (consolidated) financial statements of [client’s name] (and subsidiaries). In that connection, we will refer to your report.
Please confirm to us that your firm is independent with respect to [client’s name] and [other accountant’s client’s name] within the meaning of Rule 101, Independence (AICPA, Professional Standards, vol. 2, ET sec.101 par. .01), of the Code of Professional Conduct.

Please provide us promptly, in writing, with the following information in connection with your current examination of the financial statements of [other accountant’s client’s name] with respect to the following:

1. Related party transactions or other matters that have come to your attention. We are aware of the following related parties: [names of known related parties].

2. Any limitation on the scope of your examination that is related to the financial statements of [client’s name], or that limits your ability to respond to this inquiry.

Please update your letter to indicate any additional matters of the type designated above that have come to your attention through the date of your report on the financial statements of [other accountants’ client’s name].

Sincerely,

[Engagement Partner’s Signature]

.17 Illustrative Updating Management Representation Letter

The following letter is presented for illustrative purposes only. It may be used in the circumstances described in paragraph .12 of AU section 333. Management need not repeat all of the representations made in the previous representation letter.

If matters exist that should be disclosed to the auditor, they should be indicated by modifying the related representation. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, the final paragraph could be modified as follows: “To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred. …”

[Firm’s Letterhead]

[Date]

To [Auditor],

In connection with your audit(s) of the [identification of financial statements] of [name of entity] as of [dates] and for the [periods] for the purpose of expressing an opinion as to whether the (consolidated) financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of [name of entity] in conformity with generally accepted accounting principles, you were previously provided with a representation letter under date of [date of previous representation letter]. No information has come to our attention that would cause us to believe that any of those previous representations should be modified.

To the best of our knowledge and belief, no events have occurred subsequent to [date of latest balance sheet reported on by the auditor] and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

[Name of Chief Executive Officer and Title]

[Name of Chief Financial Officer and Title]

[The next page is 7501.]
AAM Section 7500

Communication With Those Charged With Governance

.01 AU section 380, The Auditor’s Communication With Those Charged With Governance (AICPA, Professional Standards, vol. 1), establishes standards and provides guidance on the auditor’s communication with those charged with governance in relation to an audit of financial statements. The term those charged with governance means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. For entities with a board of directors, the term encompasses the term board of directors or audit committee used elsewhere in generally accepted auditing standards (GAAS). Recognizing the importance of effective 2-way communication to the audit, AU section 380 provides a framework for the auditor’s communication with those charged with governance and identifies some specific matters to be communicated with them.

Matters to Be Communicated

.02 In accordance with paragraph .05 of AU section 380, the auditor must communicate with those charged with governance matters related to the financial statement audit that are, in the auditor’s professional judgment, significant and relevant to the responsibilities of those charged with governance in overseeing the financial reporting process. The auditor should communicate the following with those charged with governance:

a. The auditor’s responsibilities under GAAS, including that
   (1) the auditor is responsible for forming and expressing an opinion about whether the financial statements that have been prepared by management with the oversight of those charged with governance are presented fairly, in all material respects, in conformity with generally accepted accounting principles (GAAP); and
   (2) the audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

   These responsibilities may be communicated through the engagement letter, or other form of contract that records the terms of the engagement, if that letter or contract is provided to those charged with governance. See paragraphs .26–.28 of AU section 380 for additional guidance.

b. An overview of the planned scope and timing of the audit. See paragraphs .29–.33 of AU section 380 for additional guidance.

c. Significant findings from the audit, including
   (1) the auditor’s views about qualitative aspects of the entity’s significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures (see paragraphs .37–.38 of AU section 380);
   (2) significant difficulties, if any, encountered during the audit (see paragraph .39 of AU section 380);
   (3) uncorrected misstatements, other than those the auditor believes are trivial, if any (see paragraphs .40–.41 of AU section 380);
   (4) disagreements with management, if any (see paragraph .42 of AU section 380); and
(5) other findings or issues, if any, arising from the audit that are, in the auditor’s professional judgment, significant and relevant to those charged with governance regarding their oversight of the financial reporting process.

.03 Unless all of those charged with governance are involved in managing the entity, the auditor also should communicate the following:

a. Material, corrected misstatements that were brought to the attention of management as a result of audit procedures. The auditor also may communicate other corrected immaterial misstatements, such as frequently recurring immaterial misstatements that may indicate a particular bias in the preparation of the financial statements.

b. Representations the auditor is requesting from management. The auditor may provide those charged with governance with a copy of management’s written representations.

c. Management’s consultations with other accountants (see paragraph .43 of AU section 380).

d. Significant issues, if any, arising from the audit that were discussed, or were the subject of correspondence, with management (see paragraph .44 of AU section 380).

The Communication Process

.04 The auditor should communicate with those charged with governance the form, timing, and expected general content of communications. Clear communication of the auditor’s responsibilities, an overview of the planned scope and timing of the audit, and the expected general content of communications helps establish the basis for effective two-way communication. Matters that may also contribute to effective two-way communication include discussion of the following:

• The purpose of communications. When the purpose is clear, the auditor and those charged with governance are in a better position to have a mutual understanding of relevant issues and the expected actions arising from the communication process.

• The form in which communications will be made.

• The person(s) on the audit team and among those charged with governance who will communicate regarding particular matters.

• The auditor’s expectation that communication will be two-way, and that those charged with governance will communicate with the auditor matters they consider relevant to the audit. Such matters might include strategic decisions that may significantly affect the nature, timing, and extent of audit procedures; the suspicion or the detection of fraud; or concerns about the integrity or competence of senior management.

• The process for taking action and reporting back on matters communicated by the auditor.

• The process for taking action and reporting back on matters communicated by those charged with governance.

.05 The auditor should communicate in writing with those charged with governance significant findings from the audit (see paragraphs .34–.35 of AU section 380) when, in the auditor’s professional judgment, oral communication would not be adequate. This communication need not include matters that arose during the course of the audit that were communicated with those charged with governance and satisfactorily resolved. Other communications may be oral or in writing. When the auditor communicates matters in accordance with AU section 380 in writing, the auditor should indicate in the communication that it is intended solely for the information and use of those charged with governance and, if appropriate, management; and is not intended to be and should not be used by anyone other than these specified parties. When matters required to be communicated have been communicated orally, the auditor should document them. When matters have been communicated in writing, the auditor should retain a copy of the communication. Documentation of oral
communication may include a copy of minutes prepared by the entity if those minutes are an appropriate record of the communication.

.06 The auditor should communicate with those charged with governance on a sufficiently timely basis to enable those charged with governance to take appropriate action. The appropriate timing for communications will vary with the circumstances of the engagement. Considerations include the significance and nature of the matter, and the action expected to be taken by those charged with governance.

.07 The auditor should evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor should take appropriate action to address the effectiveness of the communication process.

Additional Communication Requirements

.08 Requirements for the auditor to communicate with those charged with governance are included in other standards, including the following:

a. Paragraph .17 of AU section 317, Illegal Acts by Clients (AICPA, Professional Standards, vol. 1), to communicate with the audit committee or others with equivalent authority and responsibility illegal acts that come to the auditor’s attention.

b. Paragraph .22 of AU section 801, Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance (AICPA, Professional Standards, vol. 1), to communicate to management and the audit committee (or others with equivalent authority and responsibility) when the auditor becomes aware during an audit in accordance with GAAS that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, and that an audit in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements.

c. Paragraph .22 of AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), to inquire directly of the audit committee (or at least its chair) regarding the audit committee’s views about the risks of fraud and whether the audit committee has knowledge of any fraud or suspected fraud affecting the entity.

d. Paragraph .79 of AU section 316 to communicate with those charged with governance fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements. In addition, the auditor should reach an understanding with those charged with governance regarding the nature and extent of communications with those charged with governance about misappropriations perpetrated by lower level employees.

e. Paragraph .20 of AU section 325A, Communicating Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, vol. 1),1 to communicate in writing to management and those charged with governance control deficiencies identified during an audit that upon evaluation are considered significant deficiencies or material weaknesses, including significant deficiencies and material weaknesses that were communicated in previous audits and have not yet been remediated. See examples in the following paragraphs.

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1 In October 2008, the Auditing Standards Board issued Statement on Auditing Standards (SAS) No. 115, Communicating Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, vol. 1, AU sec. 325). SAS No. 115 supersedes SAS No. 112, Communicating Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, vol. 1, AU sec. 325A). SAS No. 115 was issued to eliminate differences within the AICPA’s Audit and Attest Standards resulting from the issuance of Statement on Standards for Attestation Engagements (SSAE) No. 15, An Examination of an Entity’s Internal Control Over Financial Reporting That is Integrated With an Audit of Its Financial Statements (AICPA, Professional Standards, vol. 1, AT sec. 501). SAS No. 115 is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier application is permitted. Due to the issuance of SAS No. 115, extant AU section 325 has been moved to AU section 325A of Professional Standards until the effective date of SAS No. 115. This manual references the “A” sections as appropriate because the changes due to SAS No. 115 have not been incorporated into this edition of the manual. See AAM section ????, “Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115,” for further guidance.
In planning and performing our audit of the financial statements of [client’s name] as of and for the year ended [financial statement date], in accordance with auditing standards generally accepted in the United States of America, we considered [client’s name] internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the company’s internal control. Accordingly, we do not express an opinion on the effectiveness of the company’s internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed in the following sections, we identified certain deficiencies in internal control that we consider to be significant deficiencies and a deficiency that we consider to be a material weakness.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity’s ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity’s financial statements that is more than inconsequential will not be prevented or detected by the entity’s internal control. We consider the following deficiencies to be significant deficiencies in internal control.

Accrued Vacation

Although accrued vacation has not been recorded on the financial statements, the amount of accrued vacation must be considered in determining the fair presentation of the financial statements. The year end analysis of accrued vacation had a balance significantly lower than the prior year’s balance. The details of the analysis were traced to the attendance control cards. We found (1) the number of days earned on the listing did not agree to that recorded in the cards, (2) individuals were reported in the cards with earned vacation but were not on the listing, and (3) some of the cards appeared to not have been maintained.

Detailed records of vacation days earned and used by employees should be recorded in a timely manner and accurately maintained. At least annually, these days should be converted to dollar amounts. Management should review the conversion and consider reporting this liability on the financial statements for complete recognition of liabilities.

Discussions with the office manager revealed that not all employees are required to notify him or her when they use vacation days. All employees should be required to inform the office manager of all vacation days taken. Employees should also be asked to periodically review their vacation records with the office manager and to indicate their agreement by signing the records.

Bad Debts

During 20XX, the board approved the write-off of accounts receivable of about $ [amount] The write-off was charged to revenue rather than to bad debt expense.

Procedures for recording bad debt write-offs should be reviewed for adequacy. All adjusting entries should be reviewed by the treasurer or a member of management other than the person preparing the journal entry.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

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2 The wording in this illustrative communication is consistent with the requirements and guidance of AU section 325A. Paragraph .28 of AU section 325 provides updated wording for early adopters of AU section 325. Conforming changes to reflect the issuance of SAS No. 115 will be made in a future edition of this guide.
detected by the entity’s internal control. We believe that the following deficiency constitutes a material weakness.

**Blank Checks**

Blank checks are maintained in an unlocked cabinet along with the check signing machine.

Blank checks and the check signing machine should be locked in separate locations so as to prevent the embezzlement of funds.

This report is intended solely for the information and use of the board of directors, management, and others within the entity and is not intended to be and should not be used by anyone other than these specified parties.

Sincerely,

______________________________
[Engagement Partner]

[The next page is 7601.]
AAM Section 7600

Reliance Letter

.01 Illustrative Reliance Letter

[Addressee]:

The following is in response to your letter to our firm dated _______.

We performed an audit of [company’s] balance sheet dated December 31, 20X0, and the related statements of income, retained earnings, and cash flow for the year then ended. The financial statements were audited as of the financial statement date and the audit procedures performed were completed on March 28, 20X1 [audit report date]. No additional audit procedures were performed subsequent to March 28, 20X1.

The audit was conducted in accordance with generally accepted auditing standards (GAAS). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. However, a properly designed and executed audit may not detect a material irregularity. For example, GAAS does not require that an auditor authenticate documents, nor is an auditor trained to do so. Also, audit procedures that are effective for detecting a misstatement that is unintentional may not be effective for a misstatement that is intentional and is concealed through collusion between client personnel and third parties or among management or employees of the client.

We understand that you intend to rely on the report and associated statements in connection with [describe as precisely as possible the transaction in connection with which the third party intends to rely on the report and statements]. It should be noted that the audit procedures performed in order to render an opinion on the financial statements of [company] may not be adequate or appropriate for this purpose. Because of the limitations inherent in the audit process, we may not have detected all material misstatements. Accordingly, our audit was not intended for your benefit and should not be taken to supplant the inquiries and procedures that you should take to satisfy yourself as to [company’s] credit-worthiness. We recommend that you perform your own due diligence investigation, which should include but not be limited to the following steps [itemize]. We emphasize that this list of procedures may not be all inclusive and that we cannot provide any assurance that the procedures we have mentioned will be sufficient for your purposes.

[Signature]

[Date]

[The next page is 7701.]
AAM Section 7700

Proposal Letter

.01 Illustrative Proposal Letter

[Date]

[Name]

[Address]

Dear [Name]:

We appreciate this opportunity to present a proposal for [nature of services] and a brief description of our firm and services.

Our firm was formed in 20XX. We have [number of] partners and [number of] staff and support personnel working with clients in accounting and auditing, taxation, and various consulting services. Although we serve all size clients, our clientele consists primarily of small and medium size businesses such as yours.

Our professional objectives are to provide the highest quality services on a timely basis. As a member of the AICPA Division for Firm’s Private Companies Practice Section, our accounting and auditing practice has been subjected to a review by another firm of CPAs. We received an unqualified opinion as a result of that review. We extend our client relationships to include ongoing contact and services to achieve our services objectives.

We have extensive experience in the [type of] industry. This experience and related understanding of your industry’s operations permit us to design, perform, and complete engagements for your company effectively and at a reasonable cost.

Our services include the following:

- Accounting, Auditing, and Attestation Services
  
  Our accounting, auditing, and attestation services include annual or special audits, compilations and reviews of financial statements, and the examination and review of financial and other information under the attestation standards. We accompany our report on audited financial statements with a letter communicating deficiencies in internal control and a management letter communicating recommendations for operational efficiencies. Our purpose in making these suggestions is to help you accomplish your operational objectives. These suggestions often result in cost savings.

- Tax Services
  
  We offer diversified tax services, including assistance in all phases of federal, state, and local income taxes; estate, inheritance, and gift taxes; and payroll and other taxes. These services include tax return preparation, tax research, and representation of clients at administrative proceedings before the various taxing authorities. The objectives of our tax services are to minimize taxes and potential problems.

- Consulting Services
  
  Our consulting services are designed to assist clients in improving efficiency and profitability. Our approach offers assistance in such areas as developing plans for problem identification or implementing more effective operating controls, evaluating information systems and installing or upgrading data processing systems.

[Name], an audit partner, will be primarily responsible for your engagement.
As you requested, our proposal is for [state nature of services].

We estimate that our fees for the proposed services will be approximately $[amount], plus out-of-pocket expenses, billable as the work progresses. Our fees are based on time spent on the engagement. Should we encounter any unforeseen circumstances requiring additional time, you will be notified promptly of the situation.

Our fee estimate is based on the assumption that your personnel will prepare certain schedules and analyses for us. We also anticipate their assistance in locating invoices and other documents for our examination.

Our firm is organized and staffed to help you satisfy our business needs. Please call [number] with questions about this proposal.

Sincerely,

[ Firm Signature ]

[The next page is 8001.]


**AAM Section 8000 Alerts**

The material included in this section is intended to provide CPAs with an overview of recent economic, industry, regulatory, and professional developments that may affect audits and other engagements they perform. The material in this section has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

**TABLE OF CONTENTS**

<table>
<thead>
<tr>
<th>Section</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>8010</td>
<td>Comprehensive Audit Risk Alert—2008</td>
</tr>
<tr>
<td>8012</td>
<td>Current Economic Crisis: Accounting and Auditing Considerations—2009</td>
</tr>
<tr>
<td></td>
<td>How This Alert Helps You</td>
</tr>
<tr>
<td></td>
<td>Economic, Legislative, and Regulatory Developments</td>
</tr>
<tr>
<td></td>
<td>The State of the Economy</td>
</tr>
<tr>
<td></td>
<td>Events Leading to the Current Economic Crisis</td>
</tr>
<tr>
<td></td>
<td>Regulatory Interventions</td>
</tr>
<tr>
<td></td>
<td>Other Government Interventions</td>
</tr>
<tr>
<td></td>
<td>Resources for Economic Information</td>
</tr>
<tr>
<td></td>
<td>Accounting Issues and Developments</td>
</tr>
<tr>
<td></td>
<td>Fair Value</td>
</tr>
<tr>
<td></td>
<td>Understanding Fair Value Accounting</td>
</tr>
<tr>
<td></td>
<td>Definition of Fair Value</td>
</tr>
<tr>
<td></td>
<td>Valuation Techniques</td>
</tr>
<tr>
<td></td>
<td>Present Value Techniques</td>
</tr>
<tr>
<td></td>
<td>The Fair Value Hierarchy</td>
</tr>
<tr>
<td></td>
<td>Disclosures</td>
</tr>
<tr>
<td></td>
<td>Additional Fair Value Guidance</td>
</tr>
<tr>
<td></td>
<td>Measurements of Fair Value in Illiquid Markets</td>
</tr>
<tr>
<td></td>
<td>FASB Statement No. 159</td>
</tr>
<tr>
<td></td>
<td>Fair Value Resources</td>
</tr>
<tr>
<td></td>
<td>Other-Than-Temporary Impairment</td>
</tr>
<tr>
<td></td>
<td>Modifications of Residential Mortgage Loans</td>
</tr>
<tr>
<td></td>
<td>Liquidity Restrictions</td>
</tr>
<tr>
<td></td>
<td>Tax Exempt Debt Issues for Not for Profit Organizations</td>
</tr>
<tr>
<td></td>
<td>Other Accounting and Financial Management Considerations</td>
</tr>
<tr>
<td></td>
<td>Audit and Attestation Issues and Developments</td>
</tr>
<tr>
<td></td>
<td>Understanding the Entity and Its Environment and Performing Audit</td>
</tr>
<tr>
<td></td>
<td>Procedures in Response to Assessed Risks</td>
</tr>
<tr>
<td></td>
<td>Audit Risks Arising From Current Economic Conditions</td>
</tr>
<tr>
<td></td>
<td>Auditing Fair Value Measurements</td>
</tr>
<tr>
<td></td>
<td>Auditing Accounting Estimates</td>
</tr>
<tr>
<td></td>
<td>Using the Work of a Specialist</td>
</tr>
<tr>
<td></td>
<td>Consideration of an Entity’s Ability to Continue as a Going Concern</td>
</tr>
<tr>
<td></td>
<td>Consideration of Fraud in a Financial Statement Audit</td>
</tr>
<tr>
<td></td>
<td>Management Letter of Representations</td>
</tr>
<tr>
<td>Section</td>
<td>Paragraph</td>
</tr>
<tr>
<td>-----------------------------</td>
<td>-------------------------</td>
</tr>
<tr>
<td>8012 Current Economic Crisis: Accounting and Auditing Considerations—2009—continued</td>
<td></td>
</tr>
<tr>
<td>Communication With Those Charged With Governance</td>
<td>.153-.158</td>
</tr>
<tr>
<td>Recent Accounting, Auditing, and Attestation Pronouncements</td>
<td>.159-.161</td>
</tr>
<tr>
<td>Summary of Recent Accounting Pronouncements and Related Guidance</td>
<td>.161</td>
</tr>
<tr>
<td>Summary of Recent Auditing and Attestation Pronouncements and Related Guidance</td>
<td>.161</td>
</tr>
<tr>
<td>Recent AICPA Independence and Ethics Pronouncements</td>
<td>.162-.164</td>
</tr>
<tr>
<td>On the Horizon</td>
<td>.165-.175</td>
</tr>
<tr>
<td>Auditing Pipeline—Issuers</td>
<td>.167-.169</td>
</tr>
<tr>
<td>Accounting Pipeline</td>
<td>.170-.175</td>
</tr>
<tr>
<td>Resource Central</td>
<td>.176-.194</td>
</tr>
<tr>
<td>Publications</td>
<td>.177</td>
</tr>
<tr>
<td>AICPA reSOURCE: Accounting and Auditing Literature</td>
<td>.178</td>
</tr>
<tr>
<td>Continuing Professional Education</td>
<td>.179-.181</td>
</tr>
<tr>
<td>Webcasts</td>
<td>.182-.185</td>
</tr>
<tr>
<td>Member Service Center</td>
<td>.186</td>
</tr>
<tr>
<td>Hotlines</td>
<td>.187-.188</td>
</tr>
<tr>
<td>Conferences</td>
<td>.189-.191</td>
</tr>
<tr>
<td>The Center for Audit Quality</td>
<td>.192-.194</td>
</tr>
<tr>
<td>Appendix—Additional Web Resources</td>
<td>.195</td>
</tr>
<tr>
<td>8015 Compilation and Review Developments—2008</td>
<td></td>
</tr>
<tr>
<td>How This Alert Helps You</td>
<td>.01</td>
</tr>
<tr>
<td>Economic Developments</td>
<td>.02-.10</td>
</tr>
<tr>
<td>The State of the Economy</td>
<td>.02-.05</td>
</tr>
<tr>
<td>Small Business Trends and Conditions</td>
<td>.06-.10</td>
</tr>
<tr>
<td>Recently Issued SSARSs</td>
<td>.11-.19</td>
</tr>
<tr>
<td>Issuance of SSARS No. 16</td>
<td>.13-.17</td>
</tr>
<tr>
<td>Issuance of SSARS No. 17</td>
<td>.18-.19</td>
</tr>
<tr>
<td>Recently Issued Compilation and Review Interpretations of the SSARSs</td>
<td>.20-.30</td>
</tr>
<tr>
<td>Interpretation No. 24 of AR Section 100</td>
<td>.22-.23</td>
</tr>
<tr>
<td>Interpretation No. 30 of AR Section 100</td>
<td>.24-.30</td>
</tr>
<tr>
<td>Current ARSC Projects</td>
<td>.31-.35</td>
</tr>
<tr>
<td>Reliability</td>
<td>.31-.32</td>
</tr>
<tr>
<td>ARSC Clarity Project</td>
<td>.33-.34</td>
</tr>
<tr>
<td>Requirement to Obtain Engagement Letters</td>
<td>.35</td>
</tr>
<tr>
<td>Current Practice Issues</td>
<td>.36-.41</td>
</tr>
<tr>
<td>AICPA Guidance for Bookkeeping Engagements</td>
<td>.36</td>
</tr>
<tr>
<td>OCBOA Task Force</td>
<td>.37</td>
</tr>
<tr>
<td>SQCS No. 7, A Firm’s System of Quality Control</td>
<td>.38-.39</td>
</tr>
<tr>
<td>Accountants Engaged to Prepare Financial Statements</td>
<td>.40-.41</td>
</tr>
<tr>
<td>Common Peer Review Findings</td>
<td>.42-.43</td>
</tr>
<tr>
<td>Accounting Issues and Developments</td>
<td>.44-.53</td>
</tr>
<tr>
<td>Convergence With International Financial Reporting Standards</td>
<td>.44-.49</td>
</tr>
<tr>
<td>FASB Accounting Standards Codification™</td>
<td>.50-.53</td>
</tr>
<tr>
<td>Summary of Recent Accounting Pronouncements and Related Guidance</td>
<td>.54-.56</td>
</tr>
<tr>
<td>Deferral of FASB Interpretation No. 48 for Certain Nonpublic Entities</td>
<td>.56</td>
</tr>
<tr>
<td>Recent AICPA Independence and Ethics Pronouncements</td>
<td>.57</td>
</tr>
<tr>
<td>On the Horizon</td>
<td>.58-.66</td>
</tr>
<tr>
<td>SSARSs Pipeline</td>
<td>.60-.63</td>
</tr>
<tr>
<td>Section</td>
<td>Paragraph</td>
</tr>
<tr>
<td>---------</td>
<td>-----------</td>
</tr>
<tr>
<td>8015</td>
<td>Compilation and Review Developments—2008—continued</td>
</tr>
<tr>
<td></td>
<td>Accounting Pipeline ............................................. .64-66</td>
</tr>
<tr>
<td></td>
<td>Resource Central ................................................. .67-82</td>
</tr>
<tr>
<td></td>
<td>Publications ..................................................... .68-69</td>
</tr>
<tr>
<td></td>
<td>AICPA reSOURCE: Accounting and Attest Literature ............ .70</td>
</tr>
<tr>
<td></td>
<td>Continuing Professional Education ............................. .71-75</td>
</tr>
<tr>
<td></td>
<td>Webcasts .................................................................. .76-77</td>
</tr>
<tr>
<td></td>
<td>Member Service Center ........................................... .78</td>
</tr>
<tr>
<td></td>
<td>Hotlines ................................................................... .79-82</td>
</tr>
<tr>
<td>Appendix A—Additional Web Resources .......................... .83</td>
<td></td>
</tr>
<tr>
<td>8030</td>
<td>Health Care Industry Developments—2008 ..................... .01-133</td>
</tr>
<tr>
<td>How This Alert Helps You ......................................... .01-02</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement ............................................. .03-08</td>
</tr>
<tr>
<td></td>
<td>Economic and Industry Developments ............................ .09-22</td>
</tr>
<tr>
<td></td>
<td>The State of the Economy .......................................... .09-12</td>
</tr>
<tr>
<td></td>
<td>Industry Trends and Conditions .................................. .13-22</td>
</tr>
<tr>
<td></td>
<td>Legislative and Regulatory Developments ..................... .23-42</td>
</tr>
<tr>
<td></td>
<td>U.S. Department of Health and Human Services ............... .23-24</td>
</tr>
<tr>
<td></td>
<td>Municipal Securities Rulemaking Board .......................... .25-27</td>
</tr>
<tr>
<td></td>
<td>Centers for Medicare and Medicaid Services .................. .28-34</td>
</tr>
<tr>
<td></td>
<td>Internal Revenue Service .......................................... .35-42</td>
</tr>
<tr>
<td></td>
<td>Audit and Attestation Issues and Developments .............. .43-61</td>
</tr>
<tr>
<td></td>
<td>New Filing and Audit Requirements for ERISA-Covered 403(b) Employee Benefit Plans ............................................. .43-45</td>
</tr>
<tr>
<td></td>
<td>Medicare Recovery Audit Contractors ........................... .46-55</td>
</tr>
<tr>
<td></td>
<td>Medicare Risk Adjusters .......................................... .56-57</td>
</tr>
<tr>
<td></td>
<td>Audit Risks Arising From Current Economic Conditions ....... .58-59</td>
</tr>
<tr>
<td></td>
<td>Summary of Recent Auditing and Attestation Pronouncements and Related Guidance ............................................. .60-61</td>
</tr>
<tr>
<td></td>
<td>Accounting Issues and Developments ............................. .62-92</td>
</tr>
<tr>
<td></td>
<td>Convergence With International Financial Reporting Standards ............................................. .62-75</td>
</tr>
<tr>
<td></td>
<td>FASB Accounting Standards Codification™ ....................... .76-79</td>
</tr>
<tr>
<td></td>
<td>Accounting for Collaborative Arrangements ..................... .80-85</td>
</tr>
<tr>
<td></td>
<td>Accounting for Certain Real Estate Transactions ............ .86-87</td>
</tr>
<tr>
<td></td>
<td>Expiration of Donor-Imposed Restrictions ...................... .88-89</td>
</tr>
<tr>
<td></td>
<td>Omnibus Changes to Consolidation and Equity Method Guidance for Not-for-Profit Organizations ............................................. .90</td>
</tr>
<tr>
<td></td>
<td>Summary of Recent Accounting Pronouncements and Related Guidance ............................................. .91-92</td>
</tr>
<tr>
<td></td>
<td>Recent AICPA Independence and Ethics Pronouncements ........ .93</td>
</tr>
<tr>
<td></td>
<td>On the Horizon ...................................................... .94-109</td>
</tr>
<tr>
<td></td>
<td>Overhaul Project—AICPA Audit and Accounting Guide Health Care Organizations ............................................. .96</td>
</tr>
<tr>
<td></td>
<td>Auditing Pipeline—Nonissuers ..................................... .97</td>
</tr>
<tr>
<td></td>
<td>Auditing Pipeline—Issuers ......................................... .98</td>
</tr>
<tr>
<td></td>
<td>Accounting Pipeline ................................................ .99-109</td>
</tr>
<tr>
<td></td>
<td>Resource Central .................................................... .110-132</td>
</tr>
<tr>
<td></td>
<td>Publications .......................................................... .111-112</td>
</tr>
<tr>
<td></td>
<td>AICPA reSOURCE: Accounting and Auditing Literature .......... .113</td>
</tr>
</tbody>
</table>
## Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>8030</td>
<td>Health Care Industry Developments—2008—continued</td>
</tr>
<tr>
<td></td>
<td>Continuing Professional Education ..........</td>
</tr>
<tr>
<td></td>
<td>Webcasts ..................................</td>
</tr>
<tr>
<td></td>
<td>Member Service Center ......................</td>
</tr>
<tr>
<td></td>
<td>Hotlines ..................................</td>
</tr>
<tr>
<td></td>
<td>Industry Conference ........................</td>
</tr>
<tr>
<td></td>
<td>AICPA Governmental Audit Quality Center ....</td>
</tr>
<tr>
<td></td>
<td>The Center for Audit Quality ...............</td>
</tr>
<tr>
<td></td>
<td>AICPA Industry Expert Panel—Health Care ....</td>
</tr>
<tr>
<td></td>
<td>Industry Web Sites ........................</td>
</tr>
<tr>
<td></td>
<td>Appendix—Additional Web Resources ..........</td>
</tr>
<tr>
<td>8040</td>
<td>Insurance Industry Developments—2008 ..........</td>
</tr>
<tr>
<td></td>
<td>How This Alert Helps You ..................</td>
</tr>
<tr>
<td></td>
<td>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement ..........</td>
</tr>
<tr>
<td></td>
<td>Economic and Industry Developments ..........</td>
</tr>
<tr>
<td></td>
<td>The State of the Economy ..................</td>
</tr>
<tr>
<td></td>
<td>Industry Trends and Conditions ............</td>
</tr>
<tr>
<td></td>
<td>Legislative and Regulatory Developments ....</td>
</tr>
<tr>
<td></td>
<td>Recent Statutory Accounting Principles ......</td>
</tr>
<tr>
<td></td>
<td>The NAIC’s Sarbanes-Oxley Initiative Update</td>
</tr>
<tr>
<td></td>
<td>SSAP No. 9 Considerations ................</td>
</tr>
<tr>
<td></td>
<td>Risk-Focused Statutory Examinations ..........</td>
</tr>
<tr>
<td></td>
<td>Federal Initiatives—Treasury Department’s Blueprint for a Modernized Financial Regulatory Structure, an Optional Federal Charter, and an Office of Insurance Information</td>
</tr>
<tr>
<td></td>
<td>National Flood Insurance Program ..........</td>
</tr>
<tr>
<td></td>
<td>Terrorism Insurance Developments ...........</td>
</tr>
<tr>
<td></td>
<td>Audit and Attestation Issues and Developments</td>
</tr>
<tr>
<td></td>
<td>Audit Risks Arising From Current Economic Conditions</td>
</tr>
<tr>
<td></td>
<td>Summary of Recent Auditing and Attestation Pronouncements and Related Guidance ..........</td>
</tr>
<tr>
<td></td>
<td>Accounting Issues and Developments ..........</td>
</tr>
<tr>
<td></td>
<td>Other-Than-Temporary Impairments ...........</td>
</tr>
<tr>
<td></td>
<td>Reinsurance Arrangements ..................</td>
</tr>
<tr>
<td></td>
<td>Convergence With International Financial Reporting Standards</td>
</tr>
<tr>
<td></td>
<td>FASB Accounting Standards Codification™</td>
</tr>
<tr>
<td></td>
<td>NAIC Reinsurance Disclosure and Filing Requirements</td>
</tr>
<tr>
<td></td>
<td>Summary of Recent Accounting Pronouncements and Related Guidance</td>
</tr>
<tr>
<td></td>
<td>FASB Statement No. 163 ....................</td>
</tr>
<tr>
<td></td>
<td>Business Combinations ....................</td>
</tr>
<tr>
<td></td>
<td>Recent AICPA Independence and Ethics Pronouncements</td>
</tr>
<tr>
<td></td>
<td>On the Horizon ..........................</td>
</tr>
<tr>
<td></td>
<td>Overhaul Project—AICPA Audit and Accounting Guide Property and Liability Insurance Companies</td>
</tr>
<tr>
<td></td>
<td>Auditing Pipeline—Nonissuers ..............</td>
</tr>
<tr>
<td></td>
<td>Auditing Pipeline—Issuers ................</td>
</tr>
<tr>
<td></td>
<td>Accounting Pipeline ......................</td>
</tr>
<tr>
<td></td>
<td>Resource Central ........................</td>
</tr>
</tbody>
</table>
Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>8040</td>
<td>Insurance Industry Developments—2008—continued</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Publications</td>
<td>.127-.128</td>
</tr>
<tr>
<td></td>
<td>AICPA reSOURCE: Accounting and Auditing Literature</td>
<td>.129</td>
</tr>
<tr>
<td></td>
<td>Continuing Professional Education</td>
<td>.130-.133</td>
</tr>
<tr>
<td></td>
<td>Webcasts</td>
<td>.134-.136</td>
</tr>
<tr>
<td></td>
<td>Member Service Center</td>
<td>.137</td>
</tr>
<tr>
<td></td>
<td>Hotlines</td>
<td>.138-.139</td>
</tr>
<tr>
<td></td>
<td>The Center for Audit Quality</td>
<td>.140-.141</td>
</tr>
<tr>
<td></td>
<td>AICPA Industry Expert Panel—Insurance</td>
<td>.142</td>
</tr>
<tr>
<td></td>
<td>Industry Web Sites</td>
<td>.143-.146</td>
</tr>
<tr>
<td></td>
<td>Appendix—Additional Web Resources</td>
<td>.147</td>
</tr>
<tr>
<td>8050</td>
<td>Depository and Lending Institution Industry Developments—2008</td>
<td>.01-233</td>
</tr>
<tr>
<td></td>
<td>How This Alert Helps You</td>
<td>.01-02</td>
</tr>
<tr>
<td></td>
<td>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</td>
<td>.03-.07</td>
</tr>
<tr>
<td></td>
<td>Economic and Industry Developments</td>
<td>.08-.66</td>
</tr>
<tr>
<td></td>
<td>The State of the Economy</td>
<td>.08-.23</td>
</tr>
<tr>
<td></td>
<td>Industry Trends and Conditions</td>
<td>.24-.66</td>
</tr>
<tr>
<td></td>
<td>Legislative and Regulatory Developments</td>
<td>.67-.138</td>
</tr>
<tr>
<td></td>
<td>Proposed Interagency Appraisal and Evaluation Guidelines</td>
<td>.67-.69</td>
</tr>
<tr>
<td></td>
<td>Bank Support for Money Market Mutual Funds</td>
<td>.70-.71</td>
</tr>
<tr>
<td></td>
<td>Temporary Guarantee Program for Money Market Funds</td>
<td>.72-.74</td>
</tr>
<tr>
<td></td>
<td>Interim Rule Issued to Implement Temporary Liquidity Guarantee Program</td>
<td>.75-.77</td>
</tr>
<tr>
<td></td>
<td>Interim Final Rule on Risk Based Capital</td>
<td>.78-.80</td>
</tr>
<tr>
<td></td>
<td>SEC Proposes “Naked” Short Selling Antifraud Rule</td>
<td>.81-.82</td>
</tr>
<tr>
<td></td>
<td>Proposed Regulation on Risk Based Lending</td>
<td>.83-.86</td>
</tr>
<tr>
<td></td>
<td>NCUA to Issue Proposed Unfair or Deceptive Credit Practice Rule</td>
<td>.87-.88</td>
</tr>
<tr>
<td></td>
<td>FDIC Coverage Rules for Revocable Trusts Simplified</td>
<td>.89-.91</td>
</tr>
<tr>
<td></td>
<td>Foreclosure Prevention Proposal From the OTS</td>
<td>.92-.94</td>
</tr>
<tr>
<td></td>
<td>Illustrations of Consumer Information for Hybrid Adjustable Rate Mortgage Products</td>
<td>.95-.96</td>
</tr>
<tr>
<td></td>
<td>Bank Secrecy Act</td>
<td>.97-.100</td>
</tr>
<tr>
<td></td>
<td>Bank Securities Activities</td>
<td>.101-.106</td>
</tr>
<tr>
<td></td>
<td>FinCEN Proposal to Amend Currency Transaction Reporting Exemption Regulations</td>
<td>.107-.110</td>
</tr>
<tr>
<td></td>
<td>Managing Commercial Real Estate Concentrations in a Challenging Environment</td>
<td>.111-.114</td>
</tr>
<tr>
<td></td>
<td>Guidance on Other Real Estate</td>
<td>.115-.117</td>
</tr>
<tr>
<td></td>
<td>Housing Stabilization Measures</td>
<td>.118-.125</td>
</tr>
<tr>
<td></td>
<td>Updated Continuity Planning Booklet</td>
<td>.126</td>
</tr>
<tr>
<td></td>
<td>FDIC Proposes Changes for FDICIA Institutions</td>
<td>.127-.131</td>
</tr>
<tr>
<td></td>
<td>Credit Industry Legislation</td>
<td>.132-.133</td>
</tr>
<tr>
<td></td>
<td>Basel II Update</td>
<td>.134-.138</td>
</tr>
<tr>
<td></td>
<td>Audit and Attestation Issues and Developments</td>
<td>.139-.165</td>
</tr>
<tr>
<td></td>
<td>Auditing Fair Value Measurements</td>
<td>.139-.145</td>
</tr>
<tr>
<td></td>
<td>Liquidity Restrictions</td>
<td>.146-.147</td>
</tr>
<tr>
<td></td>
<td>Consideration of an Entity’s Ability to Continue as a Going Concern</td>
<td>.148-.149</td>
</tr>
<tr>
<td></td>
<td>Consideration of Fraud</td>
<td>.150</td>
</tr>
<tr>
<td></td>
<td>Allowance for Lease and Loan Losses</td>
<td>.151-.159</td>
</tr>
<tr>
<td>Section</td>
<td>Employee Benefit Plans Industry Developments—2009—continued</td>
<td></td>
</tr>
<tr>
<td>---------</td>
<td>-------------------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td>8060</td>
<td>Actuarial Reports for Defined Benefit Plans .................</td>
<td>.112-.119</td>
</tr>
<tr>
<td></td>
<td>Allocation Testing for Defined Contribution Plans ..........</td>
<td>.120-.123</td>
</tr>
<tr>
<td></td>
<td>Missing Participant Data ......................................</td>
<td>.124-.129</td>
</tr>
<tr>
<td></td>
<td>Securities Lending .............................................</td>
<td>.130-.132</td>
</tr>
<tr>
<td></td>
<td>Form 11-K Audits ................................................</td>
<td>.133-.141</td>
</tr>
<tr>
<td></td>
<td>Auditing Accounting Estimates ................................</td>
<td>.142-.143</td>
</tr>
<tr>
<td></td>
<td>Management Letter of Representations ........................</td>
<td>.144-.145</td>
</tr>
<tr>
<td></td>
<td>Accounting Issues and Developments ............................</td>
<td>.146-.159</td>
</tr>
<tr>
<td></td>
<td>Unrelated Business Income Tax and FASB Interpretation No. 48</td>
<td>.146-.153</td>
</tr>
<tr>
<td></td>
<td>FASB <em>Accounting Standards Codification™</em> .....................</td>
<td>.154-.159</td>
</tr>
<tr>
<td></td>
<td>Recent Pronouncements ...........................................</td>
<td>.160-.166</td>
</tr>
<tr>
<td></td>
<td>Regulatory Developments ........................................</td>
<td>.167-.305</td>
</tr>
<tr>
<td></td>
<td>The DOL Provides Guidance on Fiduciary Duties in Response to Abuses Involving the Madoff Investment Firm ........................</td>
<td>.167-.169</td>
</tr>
<tr>
<td></td>
<td>IRS Enhances Employee Plans Compliance Resolution System ..........</td>
<td>.170-.173</td>
</tr>
<tr>
<td></td>
<td>2008 Form 5500 Series ..........................................</td>
<td>.174-.184</td>
</tr>
<tr>
<td></td>
<td>Electronic Filing of Form 5500 and Changes to the 2009 Form 5500</td>
<td>.185-.187</td>
</tr>
<tr>
<td></td>
<td>Correspondence From EFAST or the DOL OCA .....................</td>
<td>.188-.197</td>
</tr>
<tr>
<td></td>
<td>The EBSA’s Inspection Programs to Assess Plan Audit Quality ..........</td>
<td>.198-.204</td>
</tr>
<tr>
<td></td>
<td>DOL Fiduciary Education Campaign ................................</td>
<td>.205-.217</td>
</tr>
<tr>
<td></td>
<td>Delinquent Filer Voluntary Compliance Program ................</td>
<td>.218-.230</td>
</tr>
<tr>
<td></td>
<td>Voluntary Fiduciary Correction Program ........................</td>
<td>.231-.235</td>
</tr>
<tr>
<td></td>
<td>DOL Outreach and Customer Service Efforts .....................</td>
<td>.236-.237</td>
</tr>
<tr>
<td></td>
<td>Timeliness of Remittance of Participant Contributions Remains an Enforcement Initiative for the EBSA .....................</td>
<td>.238-.249</td>
</tr>
<tr>
<td></td>
<td>The DOL Issues Final Rule on Investment Advice Exemption for 401(k) Plans and Individual Retirement Accounts ................</td>
<td>.250-.253</td>
</tr>
<tr>
<td></td>
<td>New Civil Penalty Rules Regarding Disclosures to Participants (ERISA Section 502(c)(4)) ..................</td>
<td>.254-.256</td>
</tr>
<tr>
<td></td>
<td>The DOL Issues Final Rule for Distributions to Missing Nonspouse Beneficiaries ................</td>
<td>.257-.260</td>
</tr>
<tr>
<td></td>
<td>The DOL Issues Final Rules on Selecting Annuity Providers for Benefit Distributions From Pension Plans ................</td>
<td>.261-.263</td>
</tr>
<tr>
<td></td>
<td>The DOL Issues Final Rule on Cross Trading ..................</td>
<td>.264-.267</td>
</tr>
<tr>
<td></td>
<td>The DOL Proposes Regulations to Improve Disclosure of Fees and Expenses to Workers With 401(k)-Type Benefit Plans ................</td>
<td>.268-.271</td>
</tr>
<tr>
<td></td>
<td>The DOL Issues Guidance on Reporting Service Provider Fee and Compensation Information (Schedule C) Reporting for 2009 Form 5500 ........................</td>
<td>.272-.275</td>
</tr>
<tr>
<td></td>
<td>Multiemployer Plan Notices ....................................</td>
<td>.276-.284</td>
</tr>
<tr>
<td></td>
<td>EBSA’s Final Rule on Default Investment Alternatives for Participant-Directed Plans ........................</td>
<td>.285-.296</td>
</tr>
<tr>
<td></td>
<td>Civil Penalty Rules For Failure to Provide Diversification Notices (ERISA Section 502(1)(7)) ................</td>
<td>.297-.300</td>
</tr>
<tr>
<td></td>
<td>Investments Reported as 103-12 Entities as Required by the DOL ..........</td>
<td>.301-.302</td>
</tr>
<tr>
<td></td>
<td>EBSA Technical Guidance .........................................</td>
<td>.303-.305</td>
</tr>
<tr>
<td></td>
<td>Recent AICPA Independence and Ethics Pronouncements ..................</td>
<td>.306</td>
</tr>
<tr>
<td></td>
<td>On the Horizon .....................................................</td>
<td>.307-.313</td>
</tr>
<tr>
<td></td>
<td>Overhaul Project—AICPA Audit and Accounting Guide Employee Benefit Plans ........................</td>
<td>.309</td>
</tr>
<tr>
<td>Section</td>
<td>Organizational Information</td>
<td>Paragraph</td>
</tr>
<tr>
<td>---------</td>
<td>-----------------------------</td>
<td>-----------</td>
</tr>
<tr>
<td>8060</td>
<td>Employee Benefit Plans Industry Developments—2009—continued</td>
<td>01-.237</td>
</tr>
<tr>
<td></td>
<td>How This Alert Helps You</td>
<td>01-02</td>
</tr>
<tr>
<td></td>
<td>Audit Risk</td>
<td>03-05</td>
</tr>
<tr>
<td></td>
<td>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</td>
<td>06-10</td>
</tr>
<tr>
<td></td>
<td>Economic and Industry Developments</td>
<td>11-69</td>
</tr>
<tr>
<td></td>
<td>The Current Economic Crisis</td>
<td>11-16</td>
</tr>
<tr>
<td></td>
<td>Government Intervention to Curtail the Economic Crisis</td>
<td>17-28</td>
</tr>
<tr>
<td></td>
<td>The State of the States’ Economy</td>
<td>29-69</td>
</tr>
<tr>
<td></td>
<td>Legislative and Regulatory Developments</td>
<td>70-103</td>
</tr>
<tr>
<td></td>
<td>Municipal Securities Rulemaking Board Activity</td>
<td>70-81</td>
</tr>
<tr>
<td></td>
<td>New IRS Regulation on Required Withholding</td>
<td>82-86</td>
</tr>
<tr>
<td></td>
<td>Red Flags Rule</td>
<td>87-92</td>
</tr>
<tr>
<td></td>
<td>New Guidance Issued on Public Housing Agencies Completion of the Financial Data Schedule and Related Auditor Reporting</td>
<td>93-100</td>
</tr>
<tr>
<td></td>
<td>Sales Tax on Internet Sales</td>
<td>101-103</td>
</tr>
<tr>
<td></td>
<td>Audit and Attestation Issues and Developments</td>
<td>104-143</td>
</tr>
<tr>
<td></td>
<td>Audit Risks Arising From Current Economic Conditions</td>
<td>104-106</td>
</tr>
<tr>
<td></td>
<td>Structured Investment Vehicles</td>
<td>107-110</td>
</tr>
<tr>
<td></td>
<td>Pensions, OPEB, and the Use of Specialists</td>
<td>111-113</td>
</tr>
<tr>
<td></td>
<td>Pollution Remediation</td>
<td>114</td>
</tr>
<tr>
<td></td>
<td>Information Technology Internal Control Issues</td>
<td>115-118</td>
</tr>
<tr>
<td></td>
<td>Auditing Accounting Estimates</td>
<td>119-122</td>
</tr>
<tr>
<td></td>
<td>Consideration of Fraud in a Financial Statement Audit</td>
<td>123-127</td>
</tr>
<tr>
<td></td>
<td>Evaluating the Existence of Assets</td>
<td>128-131</td>
</tr>
<tr>
<td></td>
<td>Communication With Those Charged With Governance</td>
<td>132-133</td>
</tr>
<tr>
<td></td>
<td>Communicating Internal Control Related Matters Identified in an Audit</td>
<td>134-143</td>
</tr>
<tr>
<td></td>
<td>Accounting Issues and Developments</td>
<td>144-187</td>
</tr>
<tr>
<td></td>
<td>GASB Accounting Standards Upcoming Implementation Dates</td>
<td>144-159</td>
</tr>
<tr>
<td>8070</td>
<td>State and Local Governmental Developments—2009</td>
<td>.01-.237</td>
</tr>
<tr>
<td></td>
<td>How This Alert Helps You</td>
<td>.01-.02</td>
</tr>
<tr>
<td></td>
<td>Audit Risk</td>
<td>.03-.05</td>
</tr>
<tr>
<td></td>
<td>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</td>
<td>.06-.10</td>
</tr>
<tr>
<td></td>
<td>Economic and Industry Developments</td>
<td>.11-.69</td>
</tr>
<tr>
<td></td>
<td>The Current Economic Crisis</td>
<td>.11-.16</td>
</tr>
<tr>
<td></td>
<td>Government Intervention to Curtail the Economic Crisis</td>
<td>.17-.28</td>
</tr>
<tr>
<td></td>
<td>The State of the States’ Economy</td>
<td>.29-.69</td>
</tr>
<tr>
<td></td>
<td>Legislative and Regulatory Developments</td>
<td>.70-.103</td>
</tr>
<tr>
<td></td>
<td>Municipal Securities Rulemaking Board Activity</td>
<td>.70-.81</td>
</tr>
<tr>
<td></td>
<td>New IRS Regulation on Required Withholding</td>
<td>.82-.86</td>
</tr>
<tr>
<td></td>
<td>Red Flags Rule</td>
<td>.87-.92</td>
</tr>
<tr>
<td></td>
<td>New Guidance Issued on Public Housing Agencies Completion of the Financial Data Schedule and Related Auditor Reporting</td>
<td>.93-.100</td>
</tr>
<tr>
<td></td>
<td>Sales Tax on Internet Sales</td>
<td>.101-.103</td>
</tr>
<tr>
<td></td>
<td>Audit and Attestation Issues and Developments</td>
<td>.104-.143</td>
</tr>
<tr>
<td></td>
<td>Audit Risks Arising From Current Economic Conditions</td>
<td>.104-.106</td>
</tr>
<tr>
<td></td>
<td>Structured Investment Vehicles</td>
<td>.107-.110</td>
</tr>
<tr>
<td></td>
<td>Pensions, OPEB, and the Use of Specialists</td>
<td>.111-.113</td>
</tr>
<tr>
<td></td>
<td>Pollution Remediation</td>
<td>.114</td>
</tr>
<tr>
<td></td>
<td>Information Technology Internal Control Issues</td>
<td>.115-.118</td>
</tr>
<tr>
<td></td>
<td>Auditing Accounting Estimates</td>
<td>.119-.122</td>
</tr>
<tr>
<td></td>
<td>Consideration of Fraud in a Financial Statement Audit</td>
<td>.123-.127</td>
</tr>
<tr>
<td></td>
<td>Evaluating the Existence of Assets</td>
<td>.128-.131</td>
</tr>
<tr>
<td></td>
<td>Communication With Those Charged With Governance</td>
<td>.132-.133</td>
</tr>
<tr>
<td></td>
<td>Communicating Internal Control Related Matters Identified in an Audit</td>
<td>.134-.143</td>
</tr>
<tr>
<td></td>
<td>Accounting Issues and Developments</td>
<td>.144-.187</td>
</tr>
<tr>
<td></td>
<td>GASB Accounting Standards Upcoming Implementation Dates</td>
<td>.144-.159</td>
</tr>
<tr>
<td>Section</td>
<td>Paragraph</td>
<td></td>
</tr>
<tr>
<td>---------</td>
<td>-----------</td>
<td></td>
</tr>
<tr>
<td>8070</td>
<td>State and Local Governmental Developments—2009—continued</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Recently Issued GASB Pronouncements and Related Guidance</td>
<td>.160-.181</td>
</tr>
<tr>
<td></td>
<td>FASB Accounting Standards Codification™</td>
<td>.182-.187</td>
</tr>
<tr>
<td></td>
<td>Recent Pronouncements</td>
<td>.188-.191</td>
</tr>
<tr>
<td></td>
<td>Recent Auditing and Attestation Pronouncements and Related Guidance</td>
<td>.189</td>
</tr>
<tr>
<td></td>
<td>Recent Accounting Pronouncements and Related Guidance</td>
<td>.190</td>
</tr>
<tr>
<td></td>
<td>Recent AICPA Independence and Ethics Pronouncements</td>
<td>.191</td>
</tr>
<tr>
<td></td>
<td>On the Horizon</td>
<td>.192-.209</td>
</tr>
<tr>
<td></td>
<td>Auditing and Attestation Pipeline—Nonissuers</td>
<td>.194-.206</td>
</tr>
<tr>
<td></td>
<td>Accounting Pipeline</td>
<td>.207-.209</td>
</tr>
<tr>
<td></td>
<td>Resource Central</td>
<td>.210-.236</td>
</tr>
<tr>
<td></td>
<td>Publications</td>
<td>.211</td>
</tr>
<tr>
<td></td>
<td>AICPA reSOURCE: Accounting and Auditing Literature</td>
<td>.212</td>
</tr>
<tr>
<td></td>
<td>AICPA Audit Committee Toolkit for Government Entities</td>
<td>.213-.215</td>
</tr>
<tr>
<td></td>
<td>Continuing Professional Education</td>
<td>.216-.220</td>
</tr>
<tr>
<td></td>
<td>Webcasts</td>
<td>.221</td>
</tr>
<tr>
<td></td>
<td>Member Service Center</td>
<td>.222</td>
</tr>
<tr>
<td></td>
<td>Hotlines</td>
<td>.223-.224</td>
</tr>
<tr>
<td></td>
<td>Industry Conferences</td>
<td>.225-.228</td>
</tr>
<tr>
<td></td>
<td>AICPA GAQC</td>
<td>.229-.231</td>
</tr>
<tr>
<td></td>
<td>AICPA Industry Expert Panel—State and Local Governments</td>
<td>.232</td>
</tr>
<tr>
<td></td>
<td>Industry Web Sites</td>
<td>.233-.236</td>
</tr>
<tr>
<td></td>
<td>Appendix—Additional Web Resources</td>
<td>.237</td>
</tr>
<tr>
<td>8080</td>
<td>Common Interest Realty Associations Industry Developments—2008</td>
<td>.01-.156</td>
</tr>
<tr>
<td></td>
<td>How This Alert Helps You</td>
<td>.01-.02</td>
</tr>
<tr>
<td></td>
<td>Audit Risk</td>
<td>.03-.05</td>
</tr>
<tr>
<td></td>
<td>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</td>
<td>.06-.10</td>
</tr>
<tr>
<td></td>
<td>Economic and Industry Developments</td>
<td>.11-.29</td>
</tr>
<tr>
<td></td>
<td>The State of the Economy</td>
<td>.11-.16</td>
</tr>
<tr>
<td></td>
<td>Industry Trends and Conditions</td>
<td>.17-.26</td>
</tr>
<tr>
<td></td>
<td>Residential Community Association Demographics</td>
<td>.27-.29</td>
</tr>
<tr>
<td></td>
<td>Legislative and Regulatory Developments</td>
<td>.30-.42</td>
</tr>
<tr>
<td></td>
<td>Select State Developments</td>
<td>.30</td>
</tr>
<tr>
<td></td>
<td>Taxation Developments</td>
<td>.31-.38</td>
</tr>
<tr>
<td></td>
<td>Other Legislation</td>
<td>.39-.42</td>
</tr>
<tr>
<td></td>
<td>Audit and Attestation Issues and Developments</td>
<td>.43-.83</td>
</tr>
<tr>
<td></td>
<td>Audit Risks Arising From Current Economic Conditions</td>
<td>.43-.82</td>
</tr>
<tr>
<td></td>
<td>Summary of Recent Auditing and Attestation Pronouncements and Related Guidance</td>
<td>.83</td>
</tr>
<tr>
<td></td>
<td>Compilation and Review Issues and Developments</td>
<td>.84-.88</td>
</tr>
<tr>
<td></td>
<td>Rescission of SOP 93-5</td>
<td>.85</td>
</tr>
<tr>
<td></td>
<td>Issuance of SSARS No. 17</td>
<td>.86-.87</td>
</tr>
<tr>
<td></td>
<td>Issuance of SSARS No. 16</td>
<td>.88</td>
</tr>
<tr>
<td></td>
<td>Accounting Issues and Developments</td>
<td>.89-.125</td>
</tr>
<tr>
<td></td>
<td>Convergence With International Financial Reporting Standards</td>
<td>.89-.104</td>
</tr>
<tr>
<td></td>
<td>FASB Accounting Standards Codification™</td>
<td>.105-.108</td>
</tr>
<tr>
<td></td>
<td>Fair Value Measurements</td>
<td>.109-.123</td>
</tr>
<tr>
<td></td>
<td>Summary of Recent Accounting Pronouncements and Related Guidance</td>
<td>.124-.125</td>
</tr>
</tbody>
</table>
## Table of Contents

**Section 8080**  
Common Interest Realty Associations Industry Developments—2008—continued

- Internal Control Issues and Developments .................................................. .126-129  
- Overview ........................................................................................................... .126-127  
- Common Internal Control Issues in the CIRA Industry ................................. .128-129  
- Recent AICPA Independence and Ethics Pronouncements ............................. .130  
- On the Horizon ................................................................................................. .131-139  
- Auditing Pipeline—Nonissuers ........................................................................ .133  
- Compilation and Review Pipeline .................................................................... .134-136  
- Accounting Pipeline ......................................................................................... .137-139  
- Resource Central ............................................................................................... .140-155  
- Publications ....................................................................................................... .141-142  
- AICPA reSOURCE: Accounting and Auditing Literature ............................... .143  
- Continuing Professional Education ................................................................. .144-147  
- Webcasts ........................................................................................................... .148-150  
- Member Service Center .................................................................................... .151  
- Hotlines ............................................................................................................ .152-153  
- Industry Web Sites ............................................................................................ .154-155  
- Appendix—Additional Web Resources ............................................................. .156

**Section 8090**  
Real Estate and Construction Industry Developments—2008 ............................. .01-185  
- How This Alert Helps You ................................................................................ .01-02  
- Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement ......................................................................................... .03-07  
- Economic and Industry Developments ............................................................. .08-56  
  - The State of the Economy .............................................................................. .08-11  
  - Real Estate and Construction Industry Trends and Conditions .................... .12-17  
  - Real Estate Industry Segment Conditions .................................................... .18-38  
  - Real Estate Investment Trusts .......................................................................... .39-40  
  - Construction Industry Conditions ................................................................. .41-50  
  - Surety Industry Trends .................................................................................... .51-53  
  - Going Green .................................................................................................... .54-56  
- Legislative and Regulatory Developments ....................................................... .57-69  
  - Commercial Real Estate Loans ....................................................................... .57-58  
  - Proposed Taxation Changes ......................................................................... .59-61  
  - Withholding Tax on Government Contracts .................................................. .62-65  
  - Government Intervention .................................................................................. .66-69  
- Audit and Attestation Issues and Developments ............................................. .70-101  
  - Audit Risks Arising From Current Economic Conditions ........................ ....... .70-79  
  - Real Estate Audit and Attestation Issues and Developments ........................ .80-85  
  - Construction Audit and Attestation Issues and Developments ...................... .86-99  
  - Summary of Recent Auditing and Attestation Pronouncements and Related Guidance .............................................................................................................. .100-101  
- Accounting Issues and Developments ............................................................. .102-120  
  - Convergence With International Financial Reporting Standards ............... .102-114  
  - FASB *Accounting Standards Codification™* ................................................... .115-118  
  - Summary of Recent Accounting Pronouncements and Related Guidance ...... .119-120  
- Real Estate Accounting Issues and Developments .......................................... .121-146  
  - Fair Value Measurements ............................................................................... .121-135  
  - Loan Modifications Within the Scope of Qualifying Special Purpose Entities ... .136-137  
  - FASB Statement No. 140 Project ..................................................................... .138-142
Table of Contents

Section 8090 Real Estate and Construction Industry Developments—2008—continued
  Buy-Sell Clauses ................................................................. .143-144
  Accounting by Lessees for Maintenance Deposits ......................... .145-146
  Construction Accounting Issues and Developments ......................... .147-150
  Revenue Recognition ............................................................. .147-150
  Recent AICPA Independence and Ethics Pronouncements .................... .151
  On the Horizon ................................................................. .152-159
  Auditing Pipeline—Nonissuers ................................................ .154
  Auditing Pipeline—Issuers ..................................................... .155
  Accounting Pipeline ............................................................ .156-159

Resource Central ....................................................................... .160-184
  Publications ........................................................................ .161-162
  AICPA reSOURCE: Accounting and Auditing Literature .................... .163
  Continuing Professional Education .............................................. .164-167
  Webcasts ........................................................................ .168-170
  Member Service Center ........................................................... .171
  Hotlines ........................................................................ .172-173
  Industry Conferences ............................................................. .174-176
  The Center for Audit Quality ..................................................... .177-178
  Industry Web Sites ................................................................. .179-184

Appendix—Additional Web Resources ............................................ .185

Section 8100 Investment Companies Industry Developments—2008 ................ .01-218
  How This Alert Helps You ......................................................... .01-02
  Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement ................................................................. .03-07
  Economic and Industry Developments ........................................... .08-24
    The State of the Economy ......................................................... .08-19
    Industry Trends and Conditions ............................................... .20-24
  Legislative and Regulatory Developments ..................................... .25-87
    SEC Concerns ................................................................ .25-40
    SEC Developments ............................................................... .41-81
  Commodity Futures Trading Commission Developments ................ .82-87
  Audit and Attestation Issues and Developments ............................ .88-127
    Audit Risks Arising From Current Economic Conditions ............... .88-99
    Auditing Fair Value Measurements .......................................... .100-111
    Using the Work of a Specialist ............................................... .112-113
    Liquidity Considerations ....................................................... .114
    Consideration of an Entity’s Ability to Continue as a Going Concern ................................................................. .115-116
    Consideration of Fraud ......................................................... .117-124
    Illustrative Report on Internal Control Required by the SEC Under FORM N-SAR ................................................................. .125
  Summary of Recent Auditing and Attestation Pronouncements and Related Guidance ................................................................. .126-127

Accounting Issues and Developments ............................................. .128-182
  Investment Companies TPAs ..................................................... .128-129
  Fair Value Measurements ......................................................... .130-151
  Disclosures About Derivative Instruments and Hedging Activities ....... .152-156
  FSP FAS 140-3 ................................................................ .157-158
  Tax Exempt Debt ................................................................ .159
## Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>8100</td>
<td>Investment Companies Industry Developments—2008—continued</td>
</tr>
<tr>
<td></td>
<td>Convergence With International Financial Reporting Standards</td>
</tr>
<tr>
<td></td>
<td>FASB Accounting Standards Codification™</td>
</tr>
<tr>
<td></td>
<td>Summary of Recent Accounting Pronouncements and Related Guidance</td>
</tr>
<tr>
<td></td>
<td>Recent AICPA Independence and Ethics Pronouncements</td>
</tr>
<tr>
<td></td>
<td>AICPA Interpretation No. 501-8</td>
</tr>
<tr>
<td></td>
<td>On the Horizon</td>
</tr>
<tr>
<td></td>
<td>Auditing Pipeline—Nonissuers</td>
</tr>
<tr>
<td></td>
<td>Auditing Pipeline—Issuers</td>
</tr>
<tr>
<td></td>
<td>Accounting Pipeline</td>
</tr>
<tr>
<td></td>
<td>Resource Central</td>
</tr>
<tr>
<td></td>
<td>Publications</td>
</tr>
<tr>
<td></td>
<td>AICPA reSOURCE: Accounting and Auditing Literature</td>
</tr>
<tr>
<td></td>
<td>Continuing Professional Education</td>
</tr>
<tr>
<td></td>
<td>Webcasts</td>
</tr>
<tr>
<td></td>
<td>Member Service Center</td>
</tr>
<tr>
<td></td>
<td>Hotlines</td>
</tr>
<tr>
<td></td>
<td>Industry Conference</td>
</tr>
<tr>
<td></td>
<td>The CAQ</td>
</tr>
<tr>
<td></td>
<td>AICPA Industry Expert Panel—Investment Companies</td>
</tr>
<tr>
<td></td>
<td>Industry Web Sites</td>
</tr>
<tr>
<td></td>
<td>Appendix—Additional Web Resources</td>
</tr>
<tr>
<td>8110</td>
<td>Securities Industry Developments—2008</td>
</tr>
<tr>
<td></td>
<td>How This Alert Helps You</td>
</tr>
<tr>
<td></td>
<td>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</td>
</tr>
<tr>
<td></td>
<td>Economic and Industry Developments</td>
</tr>
<tr>
<td></td>
<td>The State of the Economy</td>
</tr>
<tr>
<td></td>
<td>Industry Trends and Conditions</td>
</tr>
<tr>
<td></td>
<td>Legislative and Regulatory Developments</td>
</tr>
<tr>
<td></td>
<td>Regulatory Update—PCAOB</td>
</tr>
<tr>
<td></td>
<td>Regulatory Update—SEC</td>
</tr>
<tr>
<td></td>
<td>Regulatory Update—CFTC</td>
</tr>
<tr>
<td></td>
<td>Regulatory Update—Financial Industry Regulatory Authority</td>
</tr>
<tr>
<td></td>
<td>Regulatory Update—Financial Crimes Enforcement Network</td>
</tr>
<tr>
<td></td>
<td>Audit and Attestation Issues and Developments</td>
</tr>
<tr>
<td></td>
<td>Audit Risks Arising From Current Economic Conditions</td>
</tr>
<tr>
<td></td>
<td>Auditing Auction Rate Securities</td>
</tr>
<tr>
<td></td>
<td>Auditing Fair Value Measurements</td>
</tr>
<tr>
<td></td>
<td>Asset Impairment and Other Than Temporary Impairment</td>
</tr>
<tr>
<td></td>
<td>Liquidity Considerations</td>
</tr>
<tr>
<td></td>
<td>Alternative Investments</td>
</tr>
<tr>
<td></td>
<td>Consideration of an Entity’s Ability to Continue as a Going Concern</td>
</tr>
<tr>
<td></td>
<td>Disclosures</td>
</tr>
<tr>
<td></td>
<td>Consideration of Fraud</td>
</tr>
<tr>
<td></td>
<td>Summary of Recent Auditing and Attestation Pronouncements and Related Guidance</td>
</tr>
<tr>
<td></td>
<td>Accounting Issues and Developments</td>
</tr>
<tr>
<td></td>
<td>Accounting for Warrants Under TARP</td>
</tr>
<tr>
<td></td>
<td>Accounting Standards Codification™</td>
</tr>
<tr>
<td></td>
<td>Table of Contents</td>
</tr>
</tbody>
</table>
### Securities Industry Developments—2008—continued

- **Fair Value Accounting** ............................................. .107-124
- **Derivative Instruments and Hedging Activities** ............ .125-129
- **Other Recently Issued Guidance** ............................. .130-135
- **Convergence With International Financial Reporting Standards** .................................................. .136-152
- **FASB Accounting Standards Codification™** .............. .153-156
- **Summary of Recent Accounting Pronouncements and Related Guidance** ...................................... .157-158
- **Recent AICPA Independence and Ethics Pronouncements** .......................................................... .159

### On the Horizon ..................................................... .160-177
- **Auditing Pipeline—Nonissuers** ............................. .161-162
- **Auditing Pipeline—Issuers** ................................. .163-166
- **Accounting Pipeline** ........................................... .167-177

### Resource Central .................................................. .178-198
- **Publications** ...................................................... .179-180
- **AICPA reSOURCE: Accounting and Auditing Literature** ........................................................ .181
- **Continuing Professional Education** ............................. .182-183
- **Webcasts** .......................................................... .184-187
- **Member Service Center** ......................................... .188
- **Hotlines** ........................................................... .189-190
- **Industry Conference** ............................................ .191
- **The CAQ** .......................................................... .192-193
- **AICPA Industry Expert Panel—Stockbrokerage and Investment Banking** ................................... .194
- **Industry Web Sites** ............................................. .195-198

### Appendix—Additional Web Resources .......................... .199

### Not-for-Profit Entities Industry Developments—2009 ............ .01-206
- **How This Alert Helps You** ..................................... .01-02
- **Audit Risk** ........................................................ .03-05
- **Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement** .......................................................... .06-10
- **Economic and Industry Developments** ......................... .11-38
- **The Current Economic Crisis** .................................... .11-16
- **Government Intervention to Curtail the Economic Crisis** .................................................. .17-23
- **The State of NFPs** ............................................... .24-38
- **Legislative and Regulatory Developments** .................. .39-70
- **IRS Activities** ................................................... .39-60
- **Uniform Prudent Management of Institutional Funds Act** .................................................. .61-68
- **New Filing and Audit Requirements for ERISA-Covered 403(b) Employee Benefit Plans** ..................... .69
- **Other Regulatory Activities** ..................................... .70
- **Audit and Attestation Issues and Developments** ........... .71-135
- **Audit Risks Arising From Current Economic Conditions** .................................................. .71-73
- **Auditor’s Use of Reports on Service Organizations** .................................................. .74-86
- **Tax Exempt Bonds—Accounting and Auditing Considerations in the Current Environment** ......................... .87-88
- **Liquidity Considerations** ......................................... .89-90
- **Alternative Investments** .......................................... .91-93
- **Auditing Fair Value Measurements** ............................ .94-99
- **Auditing Accounting Estimates** .................................. .100-103
- **Using the Work of a Specialist** ................................. .104-105
Table of Contents

8014

Section

8120  Not-for-Profit Entities Industry Developments—2009—continued

   Consideration of an Entity’s Ability to Continue as a Going Concern ...... .106-.115
   Consideration of Fraud in a Financial Statement Audit ......................... .116-121
   Evaluating the Existence of Assets ................................................. .122-124
   Communication With Those Charged With Governance ............................ .125-126
   Communicating Internal Control Related Matters Identified in an Audit ........ .127-135

Accounting Issues and Developments .............................................. .136-158
   Fair Value ................................................................. .137-145
   Liquidity Restrictions ................................................................ .146
   FASB Accounting Standards Codification™ ........................................ .147-153
   Convergence With International Financial Reporting Standards .............. .154-156
   Accounting for Losses Due to Fraud ................................................. .157-158

Recent Pronouncements ........................................................................ .159-161
   Recent Auditing and Attestation Pronouncements and Related Guidance ...... .160
   Recent Accounting Pronouncements and Related Guidance ..................... .161
   Recent AICPA Independence and Ethics Pronouncements ........................ .162

On the Horizon ..................................................................................... .163-180
   Overhaul Project—AICPA Audit and Accounting Guide Not-for-Profit Entities .165
   Auditing and Attestation Pipeline—Nonissuers ...................................... .166-173
   Accounting Pipeline .......................................................................... .174-180

Resource Central .................................................................................. .181-205
   Publications ...................................................................................... .182-183
   AICPA reSOURCE: Accounting and Auditing Literature ............................ .184
   Continuing Professional Education ...................................................... .185-189
   Webcasts ......................................................................................... .190-192
   Member Service Center ...................................................................... .193
   Hotlines ............................................................................................ .194-195
   Industry Conferences .......................................................................... .196-197
   AICPA Governmental Audit Quality Center ........................................ .198-200
   AICPA Industry Expert Panel—Not-for-Profit Entities ............................. .201
   Industry Web Sites ............................................................................ .202-205

Appendix—Additional Web Resources ................................................... .206

8220  Government Auditing Standards and Circular A-133 Developments—2008 .... .01-117

How This Alert Helps You .................................................................... .01-04

Understanding the Entity, Its Federal Programs and Compliance Requirements,
Internal Control Over Compliance and Assessing the Risks of Material Noncompliance ........................................................... .05-11

Economic Developments ...................................................................... .12-13
   The State of the Economy ................................................................... .12-13

Legislative and Regulatory Developments .......................................... .14-61
   Report on Single Audit Quality ............................................................ .14-32

GAO Developments ............................................................................ .33-42
   OMB Developments .......................................................................... .43-50

Federal Audit Clearinghouse Developments ....................................... .51-61

U.S. Department of Housing and Urban Development Update .............. .62-69
   U.S. Department of Housing and Urban Development Consolidated Audit
     Guide Revisions .............................................................................. .62-68

HUD Proposes an Independent Public Accountant Roster .................... .69

Audit and Attestation Issues and Developments ................................... .70-85
<table>
<thead>
<tr>
<th>Section</th>
<th>Government Auditing Standards and Circular A-133 Developments—2008—continued</th>
</tr>
</thead>
<tbody>
<tr>
<td>8220</td>
<td>Summary of Recent Auditing and Attestation Pronouncements and Related Guidance</td>
</tr>
<tr>
<td></td>
<td>Audit Developments</td>
</tr>
<tr>
<td></td>
<td>AICPA Updates Audit Guide Government Auditing Standards and Circular A-133 Audits</td>
</tr>
<tr>
<td></td>
<td>AICPA Peer Review Checklists—A Tool to Help Improve Audit Quality</td>
</tr>
<tr>
<td></td>
<td>Common Deficiencies Found During Peer Reviews of Audits of Entities</td>
</tr>
<tr>
<td></td>
<td>Subject to GAS</td>
</tr>
<tr>
<td></td>
<td>Recent AICPA Independence and Ethics Pronouncements</td>
</tr>
<tr>
<td></td>
<td>Independence Requirements Under AICPA, GAS, and Circular A-133</td>
</tr>
<tr>
<td></td>
<td>On the Horizon</td>
</tr>
<tr>
<td></td>
<td>Auditing Pipeline</td>
</tr>
<tr>
<td></td>
<td>Resource Central</td>
</tr>
<tr>
<td></td>
<td>AICPA GAQC</td>
</tr>
<tr>
<td></td>
<td>AICPA State and Local Government Expert Panel</td>
</tr>
<tr>
<td></td>
<td>AICPA Not-For-Profit Organization Expert Panel</td>
</tr>
<tr>
<td></td>
<td>Publications</td>
</tr>
<tr>
<td></td>
<td>AICPA reSOURCE: Accounting and Auditing Literature</td>
</tr>
<tr>
<td></td>
<td>CPE</td>
</tr>
<tr>
<td></td>
<td>Webcasts</td>
</tr>
<tr>
<td></td>
<td>Member Service Center</td>
</tr>
<tr>
<td></td>
<td>Hotlines</td>
</tr>
<tr>
<td></td>
<td>Industry Conference</td>
</tr>
<tr>
<td></td>
<td>Industry Web Sites</td>
</tr>
<tr>
<td></td>
<td>Appendix A—Common Deficiencies Identified in the PCIF Report</td>
</tr>
<tr>
<td></td>
<td>Appendix B—Additional Web Resources</td>
</tr>
<tr>
<td>8240</td>
<td>Independence and Ethics Developments—2008</td>
</tr>
<tr>
<td></td>
<td>How This Alert Helps You</td>
</tr>
<tr>
<td></td>
<td>AICPA Independence and Ethics Developments</td>
</tr>
<tr>
<td></td>
<td>New and Revised AICPA Independence Rules</td>
</tr>
<tr>
<td></td>
<td>New Independence Guidance</td>
</tr>
<tr>
<td></td>
<td>Recognition of International Accounting Standards Board as an Accounting Standard Setter</td>
</tr>
<tr>
<td></td>
<td>Compliance Reminder Regarding Other Authoritative Bodies</td>
</tr>
<tr>
<td></td>
<td>SEC Independence Rules</td>
</tr>
<tr>
<td></td>
<td>Recent SEC Independence Information</td>
</tr>
<tr>
<td></td>
<td>PCAOB Rules Regarding Independence and Ethics</td>
</tr>
<tr>
<td></td>
<td>PCAOB Inspectors Observe Deficiencies in Independence Compliance and Controls</td>
</tr>
<tr>
<td></td>
<td>GAO Independence Standard</td>
</tr>
<tr>
<td></td>
<td>On the Horizon</td>
</tr>
<tr>
<td></td>
<td>Proposed AICPA Ethics Interpretations and Rulings</td>
</tr>
<tr>
<td></td>
<td>Other AICPA Projects</td>
</tr>
<tr>
<td></td>
<td>New and Revised PCAOB Independence Rules</td>
</tr>
<tr>
<td></td>
<td>Status of DOL Request for Comments on Independence Rules Pertaining to</td>
</tr>
<tr>
<td></td>
<td>Employee Benefit Plan Audits</td>
</tr>
<tr>
<td></td>
<td>Resource Central</td>
</tr>
<tr>
<td></td>
<td>Publications</td>
</tr>
<tr>
<td></td>
<td>AICPA reSOURCE: Accounting and Auditing Literature</td>
</tr>
<tr>
<td>Paragraph</td>
<td>Section</td>
</tr>
<tr>
<td>-----------</td>
<td>---------</td>
</tr>
<tr>
<td>.01-131</td>
<td>8260</td>
</tr>
<tr>
<td>.01-52</td>
<td>8260</td>
</tr>
<tr>
<td>.02-08</td>
<td></td>
</tr>
<tr>
<td>.09</td>
<td></td>
</tr>
<tr>
<td>.10</td>
<td></td>
</tr>
<tr>
<td>.11-14</td>
<td></td>
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<tr>
<td>.15-18</td>
<td></td>
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<tr>
<td>.19-21</td>
<td></td>
</tr>
<tr>
<td>.22-26</td>
<td></td>
</tr>
<tr>
<td>.27-41</td>
<td></td>
</tr>
<tr>
<td>.42-43</td>
<td></td>
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<tr>
<td>.44-46</td>
<td></td>
</tr>
<tr>
<td>.47-50</td>
<td></td>
</tr>
<tr>
<td>.51-52</td>
<td></td>
</tr>
<tr>
<td>.53-93</td>
<td></td>
</tr>
<tr>
<td>.54-67</td>
<td></td>
</tr>
<tr>
<td>.68-70</td>
<td></td>
</tr>
<tr>
<td>.71-75</td>
<td></td>
</tr>
<tr>
<td>.76-77</td>
<td></td>
</tr>
<tr>
<td>.78-82</td>
<td></td>
</tr>
<tr>
<td>.83-84</td>
<td></td>
</tr>
<tr>
<td>.85</td>
<td></td>
</tr>
<tr>
<td>.86-89</td>
<td></td>
</tr>
<tr>
<td>.90-93</td>
<td></td>
</tr>
<tr>
<td>.94-106</td>
<td></td>
</tr>
<tr>
<td>.94</td>
<td></td>
</tr>
<tr>
<td>.95-106</td>
<td></td>
</tr>
<tr>
<td>.107-131</td>
<td></td>
</tr>
<tr>
<td>.108-109</td>
<td></td>
</tr>
<tr>
<td>.110</td>
<td></td>
</tr>
<tr>
<td>.111-114</td>
<td></td>
</tr>
<tr>
<td>.115-117</td>
<td></td>
</tr>
<tr>
<td>.118</td>
<td></td>
</tr>
<tr>
<td>.119-120</td>
<td></td>
</tr>
<tr>
<td>.121</td>
<td></td>
</tr>
<tr>
<td>.122-124</td>
<td></td>
</tr>
<tr>
<td>.125</td>
<td></td>
</tr>
<tr>
<td>.126-131</td>
<td></td>
</tr>
<tr>
<td>Section</td>
<td>Understanding the New Auditing Standards Related to Risk Assessment</td>
</tr>
<tr>
<td>---------</td>
<td>---------------------------------------------------------------</td>
</tr>
<tr>
<td>8290</td>
<td>Introduction</td>
</tr>
<tr>
<td></td>
<td>How the Risk Assessment Standards Affect Current Practice</td>
</tr>
<tr>
<td></td>
<td>How This Alert Is Organized</td>
</tr>
<tr>
<td></td>
<td>Part One: Key Provisions of the SASs and How They Differ From Current Standards</td>
</tr>
<tr>
<td></td>
<td>SAS No. 104, Amendment to Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures (“Due Professional Care in the Performance of Work”)</td>
</tr>
<tr>
<td></td>
<td>SAS No. 105, Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards</td>
</tr>
<tr>
<td></td>
<td>SAS No. 106, Audit Evidence</td>
</tr>
<tr>
<td></td>
<td>SAS No. 107, Audit Risk and Materiality in Conducting an Audit</td>
</tr>
<tr>
<td></td>
<td>SAS No. 108, Planning and Supervision</td>
</tr>
<tr>
<td></td>
<td>SAS No. 109, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</td>
</tr>
<tr>
<td></td>
<td>SAS No. 110, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained</td>
</tr>
<tr>
<td></td>
<td>SAS No. 111, Amendment to Statement on Auditing Standards No. 39, Audit Sampling</td>
</tr>
<tr>
<td></td>
<td>Part Two: Fundamental Concepts</td>
</tr>
<tr>
<td></td>
<td>Reasonable Assurance</td>
</tr>
<tr>
<td></td>
<td>Audit Risk and the Risk of Material Misstatement</td>
</tr>
<tr>
<td></td>
<td>Materiality and Tolerable Misstatement</td>
</tr>
<tr>
<td></td>
<td>Financial Statement Assertions</td>
</tr>
<tr>
<td></td>
<td>Internal Control</td>
</tr>
<tr>
<td></td>
<td>Information Technology</td>
</tr>
<tr>
<td></td>
<td>Audit Evidence</td>
</tr>
<tr>
<td></td>
<td>Part Three: Applying the Audit Risk Model</td>
</tr>
<tr>
<td></td>
<td>Information Gathering</td>
</tr>
<tr>
<td></td>
<td>Gaining an Understanding of the Client and Its Environment</td>
</tr>
<tr>
<td></td>
<td>Assessing the Risk of Material Misstatement</td>
</tr>
<tr>
<td></td>
<td>Determining Materiality and Tolerable Misstatement</td>
</tr>
<tr>
<td></td>
<td>Responding to Assessed Risks</td>
</tr>
<tr>
<td></td>
<td>Evaluating Audit Findings</td>
</tr>
<tr>
<td></td>
<td>The Iterative Nature of Auditing</td>
</tr>
<tr>
<td></td>
<td>Audit Documentation</td>
</tr>
<tr>
<td></td>
<td>Resource Central</td>
</tr>
<tr>
<td></td>
<td>On the Bookshelf</td>
</tr>
<tr>
<td></td>
<td>AICPA/CPA2Biz Service Center</td>
</tr>
<tr>
<td></td>
<td>Hotlines</td>
</tr>
<tr>
<td></td>
<td>Web Sites</td>
</tr>
<tr>
<td>8300</td>
<td>Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115</td>
</tr>
<tr>
<td></td>
<td>Introduction</td>
</tr>
<tr>
<td></td>
<td>Why SAS No. 115 Was Issued</td>
</tr>
<tr>
<td></td>
<td>Overview of the Standard</td>
</tr>
<tr>
<td></td>
<td>Identifying Deficiencies in Internal Control</td>
</tr>
<tr>
<td></td>
<td>The Auditor’s Responsibility for Identifying Deficiencies in Internal Control</td>
</tr>
</tbody>
</table>
Communicating Internal Control Related Matters in an Audit—Understanding SAS

No. 115—continued

Evaluating Deficiencies in Internal Control ........................................... 09-.24
Communication Requirements ................................................................. 25-.32

How the Revisions Will Affect Practice .................................................. 33-.38
Discussions With Management and Others ............................................. 34-.35
Issues for Audits of Smaller Entities ....................................................... 36-.38
Examples .................................................................................................. 39-.43

Deficiencies in Internal Control, Significant Deficiencies, or Material
Weaknesses .............................................................................................. 39-.41
Significant Deficiencies ........................................................................... 42
Material Weaknesses ................................................................................ 43

Evaluation Questions .............................................................................. 44-.46
Case Studies ............................................................................................. 47-.84

Deficiency in Internal Control 1: Lack of Segregation of Duties ............... 48-.55
Deficiency in Internal Control 2: Lack of Client Expertise in Financial
Accounting and Reporting ......................................................................... 56-.68
Deficiency in Internal Control 3: Inventory-Related Deficiencies in Internal
Control ..................................................................................................... 69-.71
Deficiency in Internal Control 4: Failure to Review Modifications of Standard
Sales Contracts to Evaluate Their Effect on the Timing and Amount of
Revenue Recognition .............................................................................. 72-.79
Deficiency in Internal Control 5: Fraud Involving Cash ............................. 80-.81
Deficiency in Internal Control 6: Control Testing Exceptions .................... 82-.84

Resource Central ...................................................................................... 85-.105

Publications ............................................................................................... 86
AICPA reSOURCETM: Accounting and Auditing Literature ........................ 87
Continuing Professional Education ............................................................ 88-.89
Webcasts .................................................................................................. 90-.92
Member Service Center .......................................................................... 93
Hotlines ................................................................................................... 94-.95
AICPA Governmental Audit Quality Center ............................................. 96-.97
The Center for Audit Quality ................................................................. 98-.99
Employee Benefit Plan Audit Quality Center ......................................... 100-.105

[The next page is 8015.]
AAM Section 8010

Comprehensive Audit Risk Alert—2008

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Important Notice

The U.S. economy is experiencing a great amount of instability. During 2008 and continuing into 2009, economic conditions have deteriorated and government intervention has increased. The economic crisis undoubtedly is affecting both financial statement preparers and the auditors engaged to audit their financial statements. Few, if any, industries are immune to the effects of the crisis. Since the time the AICPA published the 2008 Comprehensive Audit Risk Alert, much in the economic situation has changed.

In light of this, the AICPA has developed a dedicated alert to address common accounting and auditing concerns relative to current market conditions. This alert, Current Economic Crisis: Accounting and Auditing Considerations—2009, replaces Comprehensive Audit Risk Alert—2008. As a subscriber to Comprehensive Audit Risk Alert you are also receiving access to Current Economic Crisis: Accounting and Auditing Considerations.

[The next page is 8021.]
AAM Section 8012

Current Economic Crisis: Accounting and Auditing Considerations—2009

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an other auditing publication as defined in AU section 150, Generally Accepted Auditing Standards (AICPA, Professional Standards, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Keira A. Lichtenstein, CPA
Technical Manager
Accounting and Auditing Publications

How This Alert Helps You

01 These unprecedented times are making accounting for transactions and auditing entities more challenging than ever. This Audit Risk Alert (alert) helps you plan and perform your audits in the current economic environment. This alert can also be used by an entity’s internal management to address areas of audit concern during these difficult and grave economic times and is an important tool in helping you identify the significant risks that may result in the material misstatement of financial statements given the current economic conditions. In today’s environment, which affects all types of businesses and industries, it is crucial to remain alert to current events and evaluate how they affect the audits you perform.

Economic, Legislative, and Regulatory Developments

The State of the Economy

02 The United States has been experiencing and is expected to continue to experience severe instability in the economy. The National Bureau of Economic Research officially declared that the United States entered into a recession in December 2007 and, at the date of this writing, has remained there for 12 months. The length of the recession and whether the United States enters into a depression is yet to be determined. Entering 2009, the term depression is being used more often. Today’s economy has also been compared to the Great Depression of the 1930s. According to BusinessWeek, “Through October 7th [2008], the U.S. stock market had its worst five-day performance since 1932 on fears of a severe economic downturn.”
Some key areas and occurrences that exhibit the gravity of the economic crisis include the following:

- Government intervention in the private sector has increased. Numerous financial institutions and automakers have received a “bailout” from the government.
- The number of residential home foreclosures has increased to record levels; in November 2008, foreclosures were up 28 percent from November 2007.
- Approximately 12 million households, or 16 percent, owe more on their mortgages than their homes are currently worth.
- The Federal Reserve has continued to decrease the federal fund interest rate. In December 2008, it set the key interest rate at a range between 0 percent and 0.25 percent.
- The demand for U.S. Treasury bills has increased at a staggering rate, which drove the interest rate for these Treasury bills to approximately 0 percent in December 2008.
- The number of jobless claims has continued to increase; the number of claims reported for the week ended December 6, 2008, reached the highest level since November 1982.
- The unemployment rate has continued to rise; in November 2008, the rate was 6.7 percent.
- Preliminary advance estimates of the third quarter 2008 gross domestic product indicate that it will be -0.5 percent.
- In November 2008, the S&P 500 plunged to an 11.5 year low, and both the Dow Jones Industrial Average and NASDAQ closed at their lowest points since March 2003.
- Treasuries Over Euro Dollar Spread reached a historic high in October 2008 at 4.63 percent.

The U.S. government has taken unprecedented actions to prevent worsening economic conditions, including facilitating the sale of ailing banks, passing the Emergency Economic Stabilization Act of 2008 (EESA), and dramatically increasing the monetary programs available from the Federal Reserve. The results of many of these actions have not been fully realized to date. To fully understand how we have arrived in this situation, it is important to understand the circumstances that brought us here.

Events Leading to the Current Economic Crisis

Some experts have attributed the current situation with the residential real estate industry to the perfect storm of circumstances: rising home values, historically low interest rates, loosening underwriting and lending standards, and the notion that housing is a fail-safe investment. As these problems with the real estate market have become evident, they have had a significant impact on the credit market. As the credit markets have become frozen and banks have become unwilling to lend to consumers or one another, the downward sloping cycle perpetuates, resulting in continued stress on the overall economy.

In 2001, the Federal Reserve dramatically cut interest rates to stimulate the economy, which was suffering from the burst of the technology bubble and the September 11th terrorist attacks. This cut in interest rates decreased the cost of mortgages, thereby stimulating demand for housing. As cheap money was flowing, home buying demand increased, real estate prices increased, underwriting standards were loosened by banks, and unconventional mortgages, such as interest only and adjustable rate mortgages, became more common. These mortgages had little to zero money put down by the homebuyer as a down payment, high loan to value ratios, teaser interest rates, and borrowers with lower credit scores. These mortgages, commonly referred to as subprime mortgages, also required very little income verification. Lenders took these actions so they could continue to capitalize on the booming residential real estate market. As a result of lenders abandoning traditional mortgages and lending policies, a growing number of homeowners entered into mortgages they could not afford. These homeowners ultimately became delinquent and, sometimes, defaulted on their mortgages.

One of the main reasons these defaults have had such an overwhelming effect on the overall economy is securitization. Many of these mortgages were sold by the original lender to another entity (in
many cases, a bank), which then pooled thousands of mortgages together into a securitization. The resulting debt securities from this securitization were purchased by a variety of entities, some of which securitize these securities further into collateralized debt obligations (CDOs).

.08 As the situation evolved and delinquencies began increasing in the residential market, lenders were unable to sell the loans they had already made. In addition, the secondary market dried up as executives became nervous about the quality of the assets, the riskiness of these investments, and the soundness of the financial institutions. This doubt inhibited banks from being able to sell loans for securitizations, which reduced liquidity and lending activity even more. As a result, investors in these securities and lenders who issued these securities have almost come to a standstill, causing a liquidity crisis, which has resulted in significant declines in the values of these existing loans and mortgage backed securities held by both lenders and investors due to the lack of demand. The liquidity crisis has also resulted in a lack of demand for investments in CDOs, as many hold securities backed by subprime mortgages, and even the short-term commercial paper market. These liquidity issues are further exacerbated by defaulting homeowners and imminent foreclosures of homes that may not be worth their outstanding loan value, which will significantly affect the actions taken by both borrowers and lenders.

.09 As the quality of the underlying assets of these securities continued to decrease, demand decreased and therefore their values did as well. As these values decreased, many banks and other entities took large write-downs to mark these assets to fair value. Market confidence started to rapidly decline and a series of previously unthinkable events occurred. Starting in March 2008, many commercial and investment banks collapsed, filed for bankruptcy, or were purchased (some with the help of the U.S. Treasury). Additionally, Fannie Mae and Freddie Mac, which had been implicitly government-sponsored entities that purchased and securitized approximately half of all residential mortgages, were taken over by the U.S. Treasury amidst concerns about their capitalization. These occurrences led to passing of the EESA in October 2008.

.10 Given these events and circumstances, banks and investors have become increasingly nervous about making loans given the uncertainty around what the future holds for themselves, the counterparty of the transaction, and the overall economy. Consequently, the economy is now in the midst of a credit freeze due to the unique circumstances previously described. This affects both general financial health and growth as businesses rely on loans to fund their daily operations, such as payroll and also to expand.

Regulatory Interventions

Consolidation of Banks

.11 During 2008, many large financial institutions have been forced by the economic conditions to consolidate and some even filed for bankruptcy. The first indication of a major breakdown in the financial sector occurred in June 2007 when 2 hedge funds of a large investment bank, which invested heavily in the subprime housing market, collapsed. Nine months later, the same investment bank was saved from bankruptcy by intervention from the Federal Reserve. The Federal Reserve mediated a sale of the investment bank to another financial institution, in addition to assuming $30 billion of the investment banks liabilities.

.12 In September 2008, another major investment bank failed despite attempts for another Federal Reserve mediated sale. Soon after, to avoid a similar fate, another major investment bank sold itself to a financial institution. This left only 2 existing major investment banks; however, shortly thereafter, these entities transformed themselves into bank holding companies.

Conversion of Investment Banks to Bank Holding Companies

.13 Late in the third quarter of 2008, the last 2 major investment banks requested, and received approval, to convert themselves from investment banks to bank holding companies. When compared to investment banks, bank holding companies are more regulated, more closely supervised, less profitable, and subject to higher capital requirements. These actions were taken to attempt to avoid the fates suffered by their competitor’s bankruptcy and consolidation.
Although changing the legal structure of the investment bank subjects them to increased regulation, the advantages of the reclassification outweigh the disadvantages. Because they are now banking holding companies, these entities have the ability to hold some assets as available for sale or held to maturity in their banking divisions (as opposed to trading). The banks also have greater access to the Federal Reserve’s lending facilities, the ability to purchase a commercial bank, and a solid deposit base to utilize for short-term cash flow purposes, as they now will now be allowed to accept customer deposits. These investment banks are in the process of decreasing their leverage to become more in line with bank holding companies. According to the Wall Street Journal, investment banks typically have leverage ratios above 20, whereas bank holding companies average a total leverage ratio of around 10. With lower leverage ratios, profits will not be as high, but losses will not be as steep either.

Experts note part of the reason for the unraveling of the investment banking model was their strong reliance on short-term credit markets to fund operations. With customer deposits to fall back on as banking holding companies, frozen short-term credit markets would not have such a profound impact on the reclassified entity’s financial health. Many feel this more regulated, less risky business model is the only way for these two companies to survive the continuing liquidity and credit crisis.

One (among many) of the reasons the investment banks ran into trouble was a ruling made by the Securities and Exchange Commission (SEC) in April 2004. At that time, the major investment banks were petitioning for an exemption from the net capital rule. This rule required certain capital cushions and limited the acceptable amount of liabilities. The exemption from the rule was granted by the SEC for investment banks with assets greater than $5 billion. According to the New York Times, “In loosening the capital rules, which are supposed to provide a buffer in turbulent times, the agency also decided to rely on the firms’ own computer models for determining the riskiness of investments, essentially outsourcing the job of monitoring risk to the banks themselves.” The underlying presumption was that the investment banks could effectively self-discipline without imposed regulations because being financially sound was, inherently, one of their main goals. The banks argued that they would know when to limit their borrowing and how much cash to hold as cushion to remain financially strong. The investment banks noted these newly unrestricted funds would be used to purchase mortgage-related securities. After this ruling was made, the leverage ratios at investment banks grew dramatically—at one point the leverage ratio at one of these major investment banks was 33 to 1. When turbulent times arrived, these banks did not have adequate capital to sustain the losses they were incurring.

By allowing a major investment bank to fail when it had saved others, the government seemed to be making the point that not all institutions would be rescued and that it was not in the business of rewarding risky behavior; its interventions were calculated and made only in select situations.

Conservatorship of Fannie Mae and Freddie Mac

Amidst the consolidations of investment banks, concerns began to mount around the capitalization of two government sponsored entities (GSEs)—Federal Home Loan Mortgage Corporation (Freddie Mac) and Federal National Mortgage Association (Fannie Mae). These 2 GSEs are the biggest market makers of mortgage-backed securities and both had implicit government backing. To calm market sentiment and inject confidence, Congress passed a bill authorizing the U.S. Treasury Department to make loans and investments in the 2 publicly traded GSEs. In early September 2008, the U.S. Treasury Department exercised this ability and acquired $1 billion of preferred shares in each GSE and pledged to provide the GSEs with up to $200 billion to weather the current real estate housing market. These preferred shares are the most senior class of equity and will therefore receive their 10 percent dividend yield first. Additionally, the U.S. Treasury, for a nominal sum, received warrants equivalent to 79.9 percent ownership in each GSE. These plans put the GSEs under a conservatorship. Their regulator, the Federal Housing Finance Agency, will control the GSEs until it deems the entities financially healthy. The executives and boards of directors of both GSEs are also being replaced. The U.S. Treasury will limit the size of each entity’s mortgage portfolios to $850 billion as of year-end 2009. Immediately following this time, the entities will decrease their mortgage portfolios by approximately 10 percent per annum until they each hold $250 billion. This has changed the perception of the 2 GSEs from being implicitly government backed to explicitly government backed.
As the economy continued to worsen, these previous interventions were trumped by the EESA.

**Emergency Economic Stabilization Act of 2008**

On October 3, 2008, due to the severity of the situation affecting the U.S. economy, Congress passed and the president immediately signed the EESA. As stated in Section 2 of the bill, it “Provides authority to the Treasury Secretary to restore liquidity and stability to the U.S. financial system and to ensure the economic well-being of Americans.” Primary components of this bill include (a) an allocation of $700 billion to stabilize the U.S. financial system; (b) creation of an oversight board, executive compensation rules, and other corporate governance rules for any entities that receive government aid; (c) an increase of the statutory limit on public debt from $10.0 trillion to $11.3 trillion; (d) a temporary increase of Federal Deposit Insurance Corporation insurance limits; (e) creation of a tax modification for Fannie Mae and Freddie Mac stock losses; (f) restatement of the SEC’s authority to suspend the application of Financial Accounting Standards Board (FASB) Statement No. 157, *Fair Value Measurements*; and (g) the requirement of the SEC to conduct a study on the impact and effects of FASB Statement No. 157.

**Troubled Assets Relief Program**

As the details of the EESA were formulating before it was passed into law, the first use of the $700 billion allocation was supposed to be to purchase illiquid mortgage-related assets from banks. This allocation was entitled the Troubled Assets Relief Program (TARP). According to Treasury Secretary Henry Paulson’s speech on November 12, 2008:

> It was clear to me by the time the bill was signed on October 3rd that we needed to act quickly and forcefully, and that purchasing troubled assets—our initial focus—would take time to implement and would not be sufficient given the severity of the problem. In consultation with the Federal Reserve, I determined that the most timely, effective step to improve credit market conditions was to strengthen bank balance sheets quickly through direct purchases of equity in banks.

This injection of capital into banks was announced on October 14, 2008, had an allocated budget of $250 billion, and was named the Capital Purchase Program (CPP). Half of funds for this program were distributed to 9 of the largest financial institutions in the nation, which hold approximately 55 percent of U.S. banking assets. The other half of the funds were allocated for smaller financial institutions. All participating institutions will have the same terms under this program. However, there is a sense of uncertainty by many about how the banks will actually use this $250 billion. The clear intent is for them to increase lending practices. The worry is that they will hoard it for possible tough times ahead. The full effects of the CPP have yet to be realized and only time will reveal how banks used this government cash injection and which benefits were provided to the economy.

This $250 billion will also purchase senior preferred shares of the participating entities. These shares are senior to common stock and *pari passu* with existing preferred shares. The only exception to this *pari passu* status would be any preferred shares, which by their terms, rank junior to any existing preferred shares. These preferred shares pay a cumulative dividend of 5 percent per annum for the first 5 years and reset to 9 percent after year 5. These shares are nonvoting (other than on matters that could adversely affect the shares) and are callable at par after 3 years. Simultaneously, the Treasury will receive warrants to purchase common stock with an aggregate market value equal to 15 percent of the senior preferred investment. These warrants have a 10 year term and the exercise price will be the market price of the institutions common stock at the time of issuance, calculated on a 20 trading day trailing average. Any participating entities must adopt the standards on executive compensation and corporate governance created by the EESA for the period the Treasury holds equity issued under this program.

After the announcement of this plan, practitioners started to consider the accounting implications of these warrants. In general, depending on the terms of warrants, some are accounted for as liabilities as they represent a future obligation. If these warrants were accounted for as liabilities, the intended benefits may be somewhat diminished due to the warrants being accounted for at fair value, thereby possibly
increasing earnings volatility and part of the capital proceeds being allocated to the warrants, which resides in the liability section of the balance sheet as opposed to in the equity section.

.25 To address this concern, the SEC and FASB issued a letter on October 24, 2008, that noted, “we would not object if the Warrants...were to be classified as permanent equity under applicable U.S. GAAP [generally accepted accounting principles], provided that the issuer of such Warrants has sufficient authorized but unissued shares of the class of stock that may be required upon settlement and any other necessary shareholder approvals have been obtained.” The letter went on to state that as long as these approvals were obtained prior to the end of the fiscal quarter in which the warrants were issued, immediate classification as permanent equity would be appropriate as well.

.26 It is unclear whether the remaining allocation of money to stabilize the economy will be directed at troubled mortgage-related assets, though many are still hoping that will occur. According to a survey conducted by the Securities Industry and Financial Markets Association and 4 other advocacy groups in November 2008, 53 percent of 445 banks said they would expect to participate if this program was carried out. The lack of clarity on whether this method will ever be implemented has had numerous effects on the market. Many institutions were hoping these purchases would occur for some price discovery on these troubled assets, which they could then leverage off of in pricing their own assets. Additionally, some institutions would consider transferring assets to held to maturity (and therefore not subject to fair value unless the assets become other-than-temporarily impaired); however, they are worried to do that if the U.S. Treasury does become a buyer for these types of assets.

.27 Late in November 2008, the Federal Reserve announced the creation of the Term Asset-Backed Securities Loan Facility. The Federal Reserve Bank of New York will lend up to $200 billion to holders of certain AAA-rated asset backed securities backed by newly and recently originated consumer and small business loans through December 31, 2009. The first $20 billion for this facility will be provided by the EESA to the Federal Reserve Bank of New York. The intent of this facility is to increase credit availability for student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration.

.28 In December 2008, the Government Accountability Office (GAO), as mandated by the EESA, published its first report on TARP to Congress. This report noted specific “areas that warrant Treasury’s ongoing attention,” which consist of the following 9 recommendations for the Treasury to implement:

- Develop a system to determine whether participating institutions activities are consistent with the underlying purpose of the CPP.
- Develop a method to ensure that participating entities of the CPP comply with the requirements of the program, such as executive compensation limits and dividend payments.
- Formalize communications with the key stakeholders (the public and Congress) to ensure an understanding of the programs current strategy and the underlying rationale.
- Develop a definitive transition plan for the new incoming presidential administration.
- Continue building a base of employees to carry out and oversee TARP.
- Ensure that appropriate amounts of personnel are assigned to oversee the performance of all contractors hired to execute TARP.
- Continue to develop a comprehensive system of internal controls over TARP activities.
- Issue final regulations on any conflicts of interest concerning contractors and financial agents.
- Institute a system to effectively manage and monitor the mitigation of conflicts of interest.

.29 Overall, the U.S. Treasury agreed with the recommendations of the GAO; however, the Treasury did have a different opinion on how best to monitor the activities of participants of the CPP. The Treasury’s method consisted of developing general metrics for evaluating the overall success of CPP, instead of working with bank regulators to establish a systematic method for determining whether entities use of CPP
funds were consistent with the purpose of the program, as recommended by the GAO. The full report can be viewed at www.gao.gov/new.items/d09161.pdf.

**Fannie Mae and Freddie Mac Stock Losses**

.30 Another key aspect of the EESA relates to losses incurred by banking organizations that either incurred losses on sales of their holdings of Fannie Mae or Freddie Mac perpetual preferred stock between January 1 and September 7, 2008, or held such stock at September 6, 2008, and then later sell or exchange it at a loss. These losses, incurred via asset sales or other-than-temporary impairments, are to be treated as ordinary losses rather than capital losses for federal income tax purposes.

.31 Under FASB Statement No. 109, *Accounting for Income Taxes*, these organizations must record the effect of this change in the period in which the law is enacted, which is the fourth quarter of 2008. In order to act in accordance with the intent of the EESA, banking organizations may adjust the tax effects associated with these losses for their third quarter regulatory capital calculations as if EESA was enacted in the third quarter of 2008. For further details on the tax change and its application, visit http://files.ots.treas.gov/481135.pdf.

**EESA Requirements Related to FASB Statement No. 157**

.32 As described in the EESA discussion, the SEC was required to conduct a study on the impact of FASB Statement No. 157, which was released on December 30, 2008. This study helped the SEC determine whether to exercise their right to suspend FASB Statement No. 157, which they decided not to do. The study was focused on the impact of FASB Statement No. 157 on financial institutions balance sheets, bank failures in 2008, the quality of financial information available to investors, the process used by FASB in developing accounting standards, and alternative accounting standards to FASB Statement No. 157. As noted in the EESA section requiring this study, the EESA restated the SECs right to suspend the application of FASB Statement No. 157. Many constituents communicated with the SEC around this possible suspension and these responses contained a wide range of opinions on the matter. Additionally, comment letters to the SEC have also been issued on the issuance of FASB Staff Position (FSP) FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*.

.33 The complete effects of the EESA will take time to be felt throughout the economy; however, the first goal of the act is to increase market confidence and liquidity. The varying methods the U.S. Treasury will employ to achieve the goals of the EESA will be seen in the coming months and years.

**Other Government Interventions**

.34 In addition to the previously discussed events, the government has taken numerous actions via the Federal Reserve and the U.S. Treasury to restore liquidity to the short-term credit markets, such as commercial paper and money market funds. In July, the Federal Reserve introduced an 84 day $25 billion term auction facility to complement its 28 day $75 billion term auction facility. In October, both of these auction facilities were increased to $150 billion each. Also in July, the Federal Reserve extended the primary dealer credit facility (PDCF) and the term securities lending facility (TSLF) through January 30, 2009; in September, the collateral for each of these facilities was broadened and the TSLF was expanded from $175 billion to $200 billion.

.35 Also in September 2008, the asset-backed commercial paper (ABCP) money market mutual funds liquidity facility (AMLF) was created. This program will extend nonrecourse loans to U.S. depository institutions and bank holding companies to finance their purchases of high quality ABCP from money market mutual funds. Another temporary program created in September, which will expire in January 2009, allows insured depository institutions to provide liquidity to their affiliates for assets typically funded in the triparty repo market. In early December 2008, the Federal Reserve extended the expiration dates of the PDCF, AMLF, and TSLF to April 2009 “in light of continuing strains in financial markets.”
To add to the liquidity measures taken by the Federal Reserve, the U.S. Treasury opened its Temporary Guarantee Program for Money Market Funds. Under this program, the U.S. Treasury guarantees the share price of participating money market funds that seek to maintain a stable net asset value of $1.00 per share, subject to certain conditions and limitations, for amounts held in participating money market funds as of the close of business on September 19, 2008. Eligible funds must be regulated under Rule 2a-7 of the Investment Company Act of 1940, must maintain a stable share price of $1, and must be publicly offered and registered with the SEC. Both taxable and nontaxable funds are eligible for this program. The program will be in effect for an initial 3 month term, after which the secretary of the Treasury will review the need and terms for the program and the costs to provide the coverage. The secretary has the option to extend the program up to the close of business on September 18, 2009. This was created after a major money market fund “broke the buck” with a net asset value under $1 due to losses from a recently bankrupted investment bank.

October 2008 saw the creation of the commercial paper funding facility (CPFF) and the money market investor funding facility (MMIFF). In the CPFF, an entity’s special purpose vehicle (SPV) purchases 3 month U.S. dollar denominated commercial paper from eligible issuers and the Federal Reserve commits to lend to the SPV on a recourse basis. The MMIFF allows the Federal Reserve to provide senior secured funding to money market funds so they can buy top-rated short-term investments such as certificates of deposit, commercial paper, and bank notes with maturities from 7 to 90 days. At the time of this writing, the MMIFF will expire in April 2009.

The extent these programs were needed can be exemplified by the ferocity with which entities signed up for participation. According to the Federal Reserve Bank of St. Louis, by October 22, 2008, bank borrowings reached $400 billion from the Federal Reserve, which is 4,000 times the level in March.

Another unique action taken by the Federal Reserve was lending an insurance conglomerate $85 billion in September 2008. In November 2008, the loan was restructured by the Federal Reserve and the U.S. Treasury into a $150 billion rescue package, including $40 billion for partial ownership. This $40 billion comes from the $700 billion allocated in the EESA and is the first time any money from that allocation was used for an entity other than a bank.

In late November 2008, the Federal Reserve announced a program to purchase the direct obligations of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks up to $100 billion. Additionally, the Federal Reserve will purchase mortgage-backed securities collateralized by Fannie Mae, Freddie Mac, and Ginnie Mae up to $500 billion. These purchases will take place over the next several quarters and are not associated with the EESA. This program has the intent of reducing the cost and increasing the availability of credit for the purchases of houses. Although these actions have helped the economy dodge further bankruptcies, it remains to be analyzed the extent to which these programs decreased the severity of the current economic crisis.

Lastly, in December 2008, the president announced a $17.4 billion rescue package for U.S. automakers. The first $13.4 billion will be lent to the automakers immediately, with the remaining $4 billion likely in the coming months. By the end of the first quarter of 2009, the borrowing automakers must prove they are financially viable, which is defined as having a positive net present value. If not, even though the loans are for 3 years, they will become due and all funds must be returned within 30 days. The U.S. government will also receive nonvoting warrants from these automakers. This is the second instance where funds have been allocated from EESA for entities other than financial institutions.

Resources for Economic Information

The Internet covers a vast amount of information that you may find valuable. Some of the sites not previously mentioned in this section and links to relevant documents regarding economic information include those shown in the following table.
Given the current economic crisis, there are a number of accounting and financial reporting issues that auditors should consider, such as the following:

- Fair value, including fair value measurements in illiquid markets
- Impairment
- Liquidity restrictions

### Fair Value

**The Need for Further Fair Value Guidance**

Among the causes cited for the economic crisis, FASB Statement No. 157 has received a great deal of attention. FASB Statement No. 157 defines fair value and establishes a framework for measuring fair value; however, it does not dictate when an entity must measure something at fair value, nor does it expand the use of fair value in any way. The beginnings of fair value accounting measurements came about in the 1970s. The need to understand fair value accounting has increased in importance as alternative investments increased in popularity and complexity. Some of the developments in fair value accounting have been in response to the savings and loan crisis and Japan’s lost decade in the 1990s.

**Fair value** is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” A contention with FASB Statement No. 157 is in regard to lack of guidance in applying fair value in an illiquid or distressed market, such as the current one. A lack of guidance also has the potential to create inconsistencies in application by accountants and auditors. The areas of FASB Statement No. 157 that relate to measuring fair value in an illiquid market are limited to the following mentions:

- “An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).”
• “Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are... [w]illing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so.”

• “For example, a transaction price might not represent the fair value of an asset or liability at initial recognition if... [t]he transaction occurs under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.”

.46 Both the SEC and FASB took notice of constituents’ desire for further guidance. On September 30, 2008, the SEC issued SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting, (SEC and FASB press release) to provide immediate clarifications on fair value in illiquid markets for preparers and auditors until FASB was able to provide additional interpretative guidance. Shortly thereafter, FASB issued FSP FAS 157-3 as authoritative guidance to clarify the application of FASB Statement No. 157 in an inactive market and to provide an illustrative example of key considerations in determining the fair value of an asset in an inactive market.

.47 As previously discussed, the EESA required the SEC to conduct a study on the impact of FASB Statement No. 157, which was released on December 30, 2008. In mid-October 2008, the SEC announced it would hold 2 roundtable discussions to assist in its mandated study of FASB Statement No. 157. The participants in these discussions included investors, issuers, auditors, and others with experience in fair value accounting. Additionally, the SEC requested public comment on the topic. These roundtable discussions occurred on October 29, 2008, and November 21, 2008.

.48 The AICPA has formally commented on the study via a letter to the Deputy Chief Accountant of the SEC. This letter states “[A]ny recommendations resulting from this study should be deliberated on and addressed by the FASB, ...[w]ith appropriate oversight by the SEC given its investor protection mandate, is best able to decide what is the most appropriate financial reporting for capital markets.” The letter also discusses the importance of transparency and neutrality in financial reporting, as well as the consideration of how the results of the study should be applied to privately held entities. Further, SEC Chairman Cox addressed some of the preliminary findings of the study in his December 8, 2008 speech at an AICPA conference. The text of his speech can be found at www.sec.gov/news/speech/2008/spch120808cc.htm. The outcome of the overall study of the effects of FASB Statement No. 157 is discussed in the “Results of SEC Study on Fair Value Accounting” section of this alert. In addition to the EESA requiring the SEC to study the effects of FASB Statement No. 157, the EESA also restated the SECs right to suspend the application of FASB Statement No. 157. To understand these issues, it is important to understand fair value accounting and some of its history, which are discussed further in the “Accounting Issues and Developments” section of this alert.

Opposition to Fair Value

.49 The constituents calling for the repeal of FASB Statement No. 157 claim it worsened the economic situation. Further, these constituents claim current accounting standards did not anticipate the wide variance and price disconnects of today’s marketplace. They argue that there should be a more appropriate and accurate measure that approximates true fair value over longer periods of time than just the immediate time frame.

.50 They assert that the standard has distorted the true value of certain assets, which forces banks to take large write-downs, which in turn led to declines in stock values. As assets kept being written down and stock prices dropped, this caused more asset write downs and a steep downward sloping cycle began that has since frozen the markets. Essentially, assets were valued at distressed prices to comply with FASB Statement No. 157, which exacerbated the current economic crisis by forcing losses and therefore hindering banks from lending.

.51 The core problem seen by opponents of FASB Statement No. 157 is the way companies are forced to value assets in illiquid markets. This general sentiment did not change after FSP FAS 157-3 was issued, as the FSP requires that liquidity risk from the buyers perspective be factored into the fair value calculation. In some constituents opinions, this requirement forces the fair value back to a distressed sale value, which they feel does not represent true fair value and is not useful to users of financial statements. A separate
Qualm with the FSP is the practicability; large banks have too many securities to apply these provisions and small banks do not have sufficient resources to apply the provisions.

Opponents argue the market value quotes being seen in these illiquid markets represent prices that companies would be willing to pay for assets they do not want to buy or that are set at prices from liquidation sales. A suggestion for valuing assets in an illiquid market is to use either economic value (where credit losses are deducted from the value) or intrinsic value.

Support for Fair Value

The proponents of FASB Statement No. 157 claim the standard merely exposed the problem; it did not create the problem. Conversely, there are many entities that strongly advocate for no suspension of FASB Statement No. 157 and are in favor of the guidance in FSP FAS 157-3 for valuing assets in illiquid markets. There are 4 primary reasons not to suspend FASB Statement No. 157 as noted by various constituents:

- Standard-setting authority should remain with an independent standard-setting body such as FASB and not become a political process.
- Fair value in accordance with FASB Statement No. 157 serves investor interests by enhancing the transparency of financial statements.
- Fair value in accordance with FASB Statement No. 157 increases comparability across companies financial statements.
- Fair value in accordance with FASB Statement No. 157 is more accurate than historical or amortized cost values and superior to other, more subjective, valuation calculations.

Proponents of FASB Statement No. 157 also believe that its issuance improved comparability across financial statements for investors. The requirement to measure items at fair value has existed since the 1970s; however, each entity applied the guidance differently. FASB Statement No. 157 defines fair value, establishes a framework to measure fair value, and requires additional disclosures to enhance investors understanding. Using an exit price, as mandated by FASB Statement No. 157, provides the most relevant, consistent, and transparent fair value to investors and other users of financial statements.

Lastly, proponents of fair value in accordance with FASB Statement No. 157 believe it is the most accurate and objective measure. Measuring assets at historical cost does not account at all for the current market conditions, whether good or bad, and therefore does not accurately reflect current values. Measuring assets at intrinsic or economic values is subjective to managements judgments as intrinsic and economic values are not uniformly defined.

However, proponents of FASB Statement No. 157 do not purport that no flaws exist with the current guidance. Although FSP FAS 157-3 was issued to provide further authoritative guidance in illiquid markets, proponents would still like more guidance due to the high levels of judgment used in applying fair value in illiquid markets. Specifically, the requests are for (a) further guidance on determining when to shift from level 2 inputs to level 3 inputs; (b) how to determine when a market is inactive or when a transaction is distressed; (c) additional examples of fair value measurements under diverse market conditions; and (d) further guidance on how to present periodic changes in asset valuation.

As described in the October 15, 2008, The Center for Audit Quality (CAQ) letter to the SEC, “a move by the SEC to suspend fair value accounting would be a disservice to the capital markets, would be inconsistent with the views of investors, would harm the credibility and independence of the standards setting process, and would run counter to fundamental notice and comment principles.”

Results of SEC Study on Fair Value Accounting

In late December 2008, the SEC released to Congress its EESA-mandated report on fair value accounting standards. This report recommends against the suspension of fair value accounting standards.
However, it does recommend improvements to existing practice, including reconsidering the accounting for impairments and the development of additional guidance for determining fair value of investments in inactive markets, including situations where market prices are not readily available.

.59 The highlights of the report include the following findings related to the key EESA mandated topics and 8 recommendations by the SEC staff:

a. First, in regard to the effect of fair value accounting standards on financial institutions balance sheets, the SEC staff observed that fair value measurements were used to measure a minority of the assets and liabilities included in financial institutions balance sheets. However, these fair value measurements did significantly affect financial institutions reported income.

b. Second, in regard to the impact of fair value accounting on bank failures in 2008, the staff observed that it did not appear to play a significant role.

c. Third, in regard to the impact of fair value accounting on the quality of financial information available to investors, the staff noted investors generally support measurements at fair value. However, many investors also indicated the need for improvements to existing fair value standards.

d. Fourth, the report confirmed that FASB, as an independent accounting standard-setter, is best positioned to develop neutral accounting guidance. However, there are steps that could be taken to enhance the existing process in terms of timeliness and transparency.

e. Fifth, the staff found that suspending FASB Statement No. 157 would lead to a reversion of practice and would likely increase investor uncertainty. Nonetheless, the issuance of additional guidance is advised.

f. Lastly, the staff provided recommendations on the advisability and feasibility of modifications to existing accounting standards and related financial report requirements.

.60 The 8 key recommendations from the report are as follows:

- FASB Statement No. 157 should be improved, but not suspended.
- Existing fair value and mark-to-market requirements should not be suspended.
- Additional measures should be taken to improve the application and practice related to existing fair value requirements (particularly as they relate to both level 2 and level 3 estimates).
- Accounting for financial asset impairments should be readdressed.
- Further guidance should be implemented to foster the use of sound judgment.
- Accounting standards should continue to be established to meet the needs of investors.
- Formal measures to address the operation of existing accounting standards in practice should be established.
- Accounting for investments in financial assets should be simplified.

.61 The changes in fair value accounting standards and the FASB standard setting process that could occur due to the results of this report will be seen in the coming months and years. For the full text of the SEC report, visit www.sec.gov/news/studies/2008/marktomarket123008.pdf.

Understanding Fair Value Accounting

Definition of Fair Value

.62 Paragraph 5 of FASB Statement No. 157 defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” That definition retains the exchange price notion in earlier definitions of fair value but clarifies that the exchange price is the price in a hypothetical transaction at the measurement date in the
A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market defined as the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability, or, in the absence of a principal market, the most advantageous market for the asset or liability.

A fair value measurement of an asset assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. Highest and best use for an asset is established by one of two valuation premises: value in-use or value in-exchange.

If the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use), the highest and best use of the asset is in-use. For example, value in-use might be appropriate for certain nonfinancial assets. An assets value in-use should be based on the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets as a group and that those other assets would be available to market participants.

If the asset would provide maximum value to market participants principally on a standalone basis, the highest and best use of the asset is in exchange. For example, value in-exchange might be appropriate for a financial asset. An assets value in-exchange is determined based on the price that would be received in a current transaction to sell the asset standalone.

A fair value measurement for a liability reflects its nonperformance risk (the risk that the obligation will not be fulfilled). Because nonperformance risk includes the reporting entity’s credit risk, the reporting entity should consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value.

Valuation Techniques

As described in FASB Statement No. 157, valuation techniques, which are consistent with the market approach, income approach, cost approach, or some combination of these approaches, should be used to measure fair value:

- The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. Valuation techniques consistent with the market approach include matrix pricing and often use market multiples derived from a set of comparables.

- The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Valuation techniques consistent with the income approach include present value techniques, option-pricing models, and the multiperiod excess earnings method.

- The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). Fair value is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

Valuation techniques that are appropriate in the circumstances and for which sufficient data are available should be used to measure fair value. In some cases, a single valuation technique will be
appropriate (for example, when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate and the respective indications of fair value should be evaluated and weighted, as appropriate.

Present Value Techniques

Appendix B of FASB Statement No. 157 provides guidance on present value techniques. Present value techniques differ in how they adjust for risk and in the type of cash flows they use. For example, the discount rate adjustment technique (also called the traditional present value technique) uses a risk-adjusted discount rate and contractual, promised, or most likely cash flows. In contrast, expected present value techniques use the probability-weighted average of all possible cash flows (referred to as expected cash flows). The traditional present value technique and 2 methods of expected present value techniques are discussed more fully in appendix B of FASB Statement No. 157.

The Fair Value Hierarchy

FASB Statement No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use when pricing the asset or liability (referred to in the statement as inputs). Paragraphs 21–31 establish a fair value hierarchy that distinguishes between (a) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (b) the reporting entity’s own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). Valuation techniques used to measure fair value should maximize the use of observable inputs and minimize the use of unobservable inputs.

The fair value hierarchy in FASB Statement No. 157 prioritizes the inputs to valuation techniques used to measure fair value into 3 broad levels:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and should be used to measure fair value whenever available, except as discussed in paragraphs 25–26 of FASB Statement No. 157.

- Level 2 inputs are inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly. Adjustments to level 2 inputs will vary depending on factors specific to the asset or liability. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall. Level 2 inputs include the following:
  - Quoted prices for similar assets or liabilities in active markets
  - Quoted prices for identical or similar assets or liabilities in markets that are not active
  - Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates)
  - Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs)

- Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. Unobservable inputs should reflect
the reporting entity’s own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk).

Disclosures

.73 Paragraphs 32–35 of FASB Statement No. 157 expand the disclosures required for assets and liabilities measured at fair value. For assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition or that are measured on a nonrecurring basis in periods subsequent to initial recognition, the statement requires the reporting entity to disclose certain information that enables users of its financial statements to assess the inputs used to develop those measurements. For recurring fair value measurements using significant unobservable inputs (level 3), the reporting entity is required to disclose certain information to help users assess the effect of the measurements on earnings (or changes in net assets) for the period.

Additional Fair Value Guidance

.74 Since FASB Statement No. 157 was issued, a number of FSPs have been issued. In February 2008, FASB issued FSP FAS 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13, which amends FASB Statement No. 157, to exclude FASB Statement No. 13, Accounting for Leases, and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under FASB Statement No. 13. However, this scope exception does not apply to assets acquired and liabilities assumed in a business combination that are required to be measured at fair value under FASB Statement No. 141, Business Combinations, or FASB Statement No. 141 (revised 2007), regardless of whether those assets and liabilities are related to leases. This FSP is effective upon the initial adoption of FASB Statement No. 157.

.75 FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. However, in February 2008, FASB also issued FSP FAS 157-2, Effective Date of FASB Statement No. 157, which is effective upon issuance. This FSP delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow FASB and its constituents the time to consider the various implementation issues associated with FASB Statement No. 157. As previously mentioned, in October 2008, FASB issued FSP FAS 157-3, which clarifies FASB Statement No. 157’s application in an inactive market and also amends the standard to include an illustrative example.

Measurements of Fair Value in Illiquid Markets

.76 Given the state of the market, there is confusion around the use of market quotes and whether current market prices represent fair value in accordance with FASB Statement No. 157 or are in actuality distressed sales. On September 30, 2008, while FASB was going through its due process to issue interpretative guidance, the SEC issued the SEC and FASB press release in an effort to assist preparers and auditors by providing immediate clarification. Ten days later, FASB issued FSP FAS 157-3. This FSP noted the consistency between the guidance provided in it and the guidance provided in the SEC and FASB press release.

.77 FSP FAS 157-3 noted the following:

Broker (or pricing service) quotes may be an appropriate input when measuring fair value, but they are not necessarily determinative if an active market does not exist for the financial asset. ... In weighing a broker quote as an input to a fair value measurement, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence.
Two other factors to consider regarding the reliability of a quote are whether it can be determined that market participants currently are transacting at that price and the appropriateness of the valuation technique employed by the pricing service to arrive at the quoted price.

As discussed in paragraph 7 of FASB Statement No. 157, “an orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).” Low transaction volume involving such assets does not necessarily translate into forced sales, nor does it necessarily mean the market is inactive. The market would still be considered active as long as the frequency and volume of transactions are sufficient to provide reliable pricing information. Additionally, the size of an entity’s position should not be a factor in this determination. To deem a transaction forced or disorderly, persuasive evidence and judgment are required.

If transaction volume is too low to provide accurate pricing information and therefore not a level 1 input, those observable transactions are to be considered level 2 inputs or even level 3 inputs if they are significantly adjusted. In October 2007, the CAQ, which is affiliated with the AICPA, issued a white paper on the topic and noted that some characteristics of an inactive market are “few transactions for the asset, the prices are not current, price quotations vary substantially, or in which little information is released publicly.” In describing an inactive market as well, the SEC and FASB press release noted, “A significant increase in the spread between the amount sellers are asking and the price that buyers are bidding, or the presence of a relatively small number of bidding parties, are indicators that should be considered in determining whether a market is inactive.”

The lack of an active market and the information obtained from it require further analysis. According to FSP FAS 157-3, “[i]n cases where the volume and level of trading activity in the asset have declined significantly, the available prices vary significantly over time or among market participants, or the prices are not current, the observable inputs might not be relevant and could require significant adjustment.” Further, the SEC and FASB press release noted that “in some cases using unobservable inputs (level 3) might be more appropriate than using observable inputs (level 2); for example, when significant adjustments are required to observable inputs it may be appropriate to utilize an estimate based primarily on unobservable inputs.” When significant adjustments are made to an observable input (level 2), it becomes a level 3 fair value measurement. The level of activity in the market in which transactions occur (that is, whether the market is active or inactive) is an indicator of the extent to which the entity will have relevant observable market data that will not require a significant adjustment in its determination of fair value.

Paragraph C85 of FASB Statement No. 157 states that “the reporting entity may use its own data to develop unobservable inputs, provided that there is no information reasonably available without undue cost and effort that indicates that market participants would use different assumptions in pricing the asset or liability.” A reporting entity is prohibited from ignoring observable transaction or assumptions that are reasonably available without undue cost and effort.

The FSP concluded that “the use of a reporting entity’s own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available.” Similarly, the SEC and FASB press release noted, “In some cases, multiple inputs from different sources may collectively provide the best evidence of fair value. In these cases expected cash flows would be considered alongside other relevant information. The weighting of the inputs in the fair value estimate will depend on the extent to which they provide information about the value of an asset or liability and are relevant in developing a reasonable estimate.”

Readers are encouraged to review the full text of the FSP and the amended standard (inclusive of its recently added illustrative example) on the FASB Web site at www.fasb.org. The FSP was effective upon issuance, including any prior periods for which financial statements have not been issued. Any revisions from changes in valuation techniques or their application shall be accounted for as a change in accounting estimate in accordance with FASB Statement No. 154, Accounting Changes and Error Corrections—a replacement
of APB Opinion No. 20 and FASB Statement No. 3; however, the disclosure provisions of FASB Statement No. 154 for such revisions are not required.

**International Accounting Standards Board Fair Value Guidance**

.85 In October 2008, the International Accounting Standards Board (IASB) issued the staff summary “Using judgment to measure the fair value of financial instruments when markets are no longer active,” which accompanies the IASB expert advisory panel report “Measuring and disclosing the fair value of financial instruments in markets that are no longer active.” The summary takes into consideration and is consistent with FSP FAS 157-3 and the SEC and FASB press release. Additionally, the summary notes the consistency between FSP FAS 157-3 and the SEC and FASB press release with International Accounting Standard No. 39, *Financial Instruments: Recognition and Measurement*.

**FASB Statement No. 159**

.86 Subsequent to the issuance of FASB Statement No. 157, FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*. This statement is expected to expand the use of fair value measurement, which is consistent with FASB’s long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159 allows entities to choose to measure many financial instruments and certain other items at fair value. The standard permits an entity to elect the fair value option on an instrument-by-instrument basis; and once the election is made, it is irrevocable. This statement’s objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently, without having to apply complex hedge accounting provisions.

.87 In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and FASB Statement No. 157.

.88 FASB Statement No. 159 is effective as of the beginning of an entity’s first fiscal year after November 15, 2007. FASB and the SEC expressed concern in the way some early adopters applied the transition provisions of the standard. The CAQ issued an alert on this development in April 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles-based standard, such as this, is applied in a good faith manner consistent with those objectives and principles. Specifically, the alert warns auditors to “be alert for circumstances in which an entity proposes to adopt FASB Statement No. 159 in a manner that is contrary to the principles and objectives outlined in the standard.” The alert can be accessed at [www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf](http://www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf).

**Fair Value Resources**

.89 The Internet covers a vast amount of information that you may find valuable. Some of the sites not previously mentioned in this section and links to relevant documents regarding fair value measurements include those shown in the following table:

<table>
<thead>
<tr>
<th>Organization/Topic</th>
<th>Web Site</th>
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<tbody>
<tr>
<td>Accounting Standards Executive Committee and AICPA Comment Letters</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/comltrs/">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/comltrs/</a></td>
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<tr>
<td>AICPA Frequently Asked Questions About Fair Value Accounting</td>
<td><a href="http://www.aicpa.org/mediacenter/fva_faq.htm">www.aicpa.org/mediacenter/fva_faq.htm</a></td>
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<tr>
<td>The Center for Audit Quality (CAQ) Comment Letters</td>
<td><a href="http://www.thecaq.org/resources/commentletters.htm">www.thecaq.org/resources/commentletters.htm</a></td>
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<tr>
<td>Chartered Accountants of Canada CPR Alert MD&amp;A Disclosures in Volatile and Uncertain Times</td>
<td><a href="http://www.cica.ca/download.cfm?ci_id=47101&amp;la_id=1&amp;re_id=0">www.cica.ca/download.cfm?ci_id=47101&amp;la_id=1&amp;re_id=0</a></td>
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<tr>
<td>Financial Accounting Standards Board (FASB) Valuation Resources Group</td>
<td><a href="http://www.fasb.org/project/valuation_resource_group.shtml">www.fasb.org/project/valuation_resource_group.shtml</a></td>
</tr>
<tr>
<td>International Auditing and Assurance Standards Board Staff Audit Practice Alert Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment</td>
<td><a href="http://web.ifac.org/download/Staff_Audit_Practice_Alert.pdf">http://web.ifac.org/download/Staff_Audit_Practice_Alert.pdf</a></td>
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<td>IASB Staff Summary “Using judgment to measure the fair value of financial instruments when markets are no longer active”</td>
<td><a href="http://www.iasb.org/NR/rdonlyres/F3AFDA4D-6605-42CE-858F-23BBB9044355/0/IASB_Staff_Summary_October_2008.pdf">www.iasb.org/NR/rdonlyres/F3AFDA4D-6605-42CE-858F-23BBB9044355/0/IASB_Staff_Summary_October_2008.pdf</a></td>
</tr>
<tr>
<td>PCAOB Staff Audit Practice Alert No. 2, Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 400 par. 02)</td>
<td><a href="http://www.pcaob.org/standards/staff_Questions_and_Answers/2007/12-10_APA_2.pdf">www.pcaob.org/standards/staff_Questions_and_Answers/2007/12-10_APA_2.pdf</a></td>
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<tr>
<td>PCAOB Standing Advisory Group Meeting Emerging Issue Audit Considerations in the Current Economic Environment</td>
<td><a href="http://www.pcaob.org/Standards/Standing_Advisory_Group/Meetings/2008/10-22/BP_Audit_Considerations.pdf">www.pcaob.org/Standards/Standing_Advisory_Group/Meetings/2008/10-22/BP_Audit_Considerations.pdf</a></td>
</tr>
<tr>
<td>SEC Spotlight On Fair Value Accounting Standards</td>
<td><a href="http://sec.gov/spotlight/fairvalue.htm">http://sec.gov/spotlight/fairvalue.htm</a></td>
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**Other-Than-Temporary Impairment**

.90 Determining when an investment is other-than-temporarily impaired is another important topic that has received increased attention in today’s economic environment. FSP FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary and Its Application to Certain Investments*, addresses the determination of when an investment is considered impaired, whether the impairment is other-than-temporary, and the
measurement of the impairment loss. Also included in the FSP are accounting issues to be considered subsequent to the recognition of other-than-temporary impairments and related disclosures about unrealized losses as a result of the other-than-temporary impairment. The guidance in this FSP applies to (a) debt and equity securities within the scope of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, (b) debt and equity securities within the scope of FASB Statement No. 124, Accounting for Certain Investments Held by Not-for-Profit Organizations, and that are held by an investor that reports a performance indicator, and (c) equity securities not within the scope of FASB Statement Nos. 115 and 124 and not accounted for under the equity method pursuant to Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock. The remaining discussion focuses on impairment of debt and equity securities. However, the auditor should also be alert for all types of assets which can become impaired, including goodwill, deferred tax assets, and real property. Given the current economic situation, entities should be alert to values of many types of assets on the balance sheet and possible impairment issues. Readers should consult the appropriate accounting requirements for further information. For further details on impairment for equity method investments and the full text of the FSP, please visit the FASB Web site at www.fasb.org.

.91 According to FSP FAS 115-1 and 124-1, “Impairment shall be assessed at the individual security level. An investment is impaired if the fair value of the investment is less than its cost. (Cost includes any adjustments made to the cost basis of an investment for accretion, amortization, previous other-than-temporary impairments, and hedging.)” Investors shall assess impairment in each reporting period. If it is determined, based on these criteria, that impairment has occurred, the next step is to determine whether it is temporary or other-than-temporary. As noted in footnote 4 of the FSP, “Other than temporary does not mean permanent.” For additional guidance on determining if an impairment is other-than-temporary, the FSP refers users to FASB Statement No. 115; Emerging Issues Task Force (EITF) Issue No. 99-20, “Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets”; and SEC Staff Accounting Bulletin (SAB) Topic 5.M, Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities (previously referred to as SAB No. 59).

.92 Paragraph 16 of FASB Statement No. 115 notes, “If it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred.” SAB Topic 5.M expands with the following additional factors which might indicate a decline is other-than-temporary:

- The duration and extent to which the fair value is below cost
- The financial health of the issuer
- The intent and ability of the investor to hold the investment until it has recovered

.93 The September 30, 2008, SEC and FASB press release reiterated the preceding criteria from SAB Topic 5.M. An additional comment in this release noted, “In general, the greater the decline in value, the greater the period of time until anticipated recovery, and the longer the period of time that a decline has existed, the greater the level of evidence necessary to reach a conclusion that an other-than-temporary decline has not occurred.”

.94 EITF Issue No. 99-20 applies to beneficial interests that continue to be held by a transferor in securitization transactions that are accounted for as sales and purchased beneficial interests in securitized financial assets. If the fair value of the beneficial interest is less than the reference amount, the security should be evaluated for impairment. The reference amount is equivalent to the initial cost less cash received to date less other-than-temporary impairments recognized to date plus the yield accreted to date. Consistent with paragraph 16 of FASB Statement No. 115, EITF Issue No. 99-20 states, “If, based on a holders best estimate of cash flows that a market participant would use in determining the current fair value of the beneficial interest, there has been an adverse change in estimated cash flows...an other-than-temporary impairment should be considered to have occurred.”
Determining whether an other-than-temporary impairment has occurred requires significant judgment by the preparer of the financial statements based upon numerous considerations; generally accepted accounting principles (GAAP) do not provide any suggestions in making this conclusion. Readers are encouraged to read the full text of FSP FAS 115-1 and FAS 124-1, the SEC and FASB press release, SAB Topic 5.M, FASB Statement No. 115, and EITF Issue No. 99-20.

On October 14, 2008, the SEC issued a letter to FASB with additional guidance on how to assess declines in fair value for perpetual preferred securities (PPS). Prior to this issuance, the SEC had received a number of inquiries on this topic including a letter from the American Bankers Association and a letter from the CAQ. PPS are classified as equity securities in accordance with FASB Statement No. 115 because they are not required to be redeemed by the issuer, nor are they redeemable at the option of the investor. Further, the SEC noted that FASB Statement No. 115 does not specifically address the impact of the debt-like characteristics of PPS on the assessment of other-than-temporary impairment. Until this matter can be further addressed by FASB, the SEC concluded that “it would not object to an issuer for impairment tests in filings subsequent to the date of this letter applying an impairment model (including an anticipated recovery period) similar to a debt security provided there has been no evidence of a deterioration in credit of the issuer (for example, a decline in the cash flows from holding the investment or a downgrade of the rating of the security below investment grade).” Further, an issuer should follow disclosure requirements required by FSP FAS 115-1 and FAS 124-1 if the cost of a PPS exceeds the fair value. The full text of the letter can be found at www.sec.gov/info/accountants/staffletters/fasb101408.pdf.

Modifications of Residential Mortgage Loans

In the current market environment where many homeowners are unable to make their mortgage payments, lenders have turned to restructuring mortgages as a way to prevent default and foreclosure. Methods of restructuring include, but are not limited to, reducing the interest rate, forgiving a portion of the principal, and extending the life of the loan. As a result of these restructurings, many of these residential mortgage loans will be subject to FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan, for the first time. Paragraph 6(a) of FASB Statement No. 114 excludes from its scope “large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment”. However, as discussed in paragraph 9, a loan that is initially excluded from the scope of the statement, but whose terms are modified in a troubled debt restructuring, becomes subject to the provisions of the statement once the loan is restructured. A troubled debt restructuring as used in this scenario is consistent with the definition stated in paragraph 2 of FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, which describes a troubled debt restructuring as a situation where “the creditor for economic or legal reasons related to the debtor’s financial difficulties grants a concession to the debtor that it would not otherwise consider.” To address and assist during this growing situation of first time appliers of FASB Statement No. 114, the CAQ issued a white paper in December 2008, Application of Statement 114 to Modifications of Residential Mortgage Loans That Qualify as Troubled Debt Restructurings.

Readers are encouraged to view the full text of the FASB statement and the CAQ white paper on the FASB Web site and at http://thecaq.org/newsroom/pdfs/FAS114_LoanModifications.pdf.

Liquidity Restrictions

The AICPA staff has issued the new nonauthoritative Technical Practice Aid (TPA) Technical Questions and Answers (TIS) 1100.15, “Liquidity Restrictions” (AICPA, Technical Practice Aids), which addresses the potential accounting and auditing implications when a fund or its trustee imposes restrictions on a nongovernmental entity’s ability to withdraw its balance in a money market fund or other short term investment vehicle. The TIS section discusses some considerations for when these restriction events occur, such as determining (a) whether any assets subject to these restrictions qualify as cash equivalents or current assets; (b) whether disclosures about the risks and uncertainties resulting from such restrictions should be made; (c) whether these restrictions may trigger violations of debt covenants and consequently if that liability should be classified as current; (d) if the occurrence of such restriction occurs between the balance sheet date and the issuance date, whether the financial statements need to be adjusted; and (e) if the
restriction events call into question the entity’s ability to continue as a going concern. For further details, please find the TIS section at www.aicpa.org/download/acctstd/TIS1100_15.pdf.

Tax Exempt Debt Issues for Not for Profit Organizations

.100 The current credit environment has affected the market for debt securities. Although all debt securities may be affected, particular issues affect not-for-profit organizations issuing tax exempt debt. Some examples of these tax exempt debt securities are auction rate securities and variable rate demand obligations.

.101 Although each situation is different and should be evaluated based on its own specific facts and circumstances, the current situation may raise various accounting and auditing issues pertaining to issuers of tax exempt debt, including, but not limited to, the following:

- Bond restructurings
- Derivative and hedge accounting implications
- Potential violation of debt covenants
- Classification of the debt on the balance sheet as either a current or noncurrent liability
- Subsequent event disclosures
- Going concern issues

.102 For further information, refer to a nonauthoritative article the AICPA has posted to its Web site, authored by a group of AICPA members, Tax-Exempt Bonds—Accounting and Auditing Considerations in the Current Environment. The article can be accessed at www.aicpa.org/download/acctstd/ars_article14.pdf.

Other Accounting and Financial Management Considerations

.103 Operating in the current economic environment produces various challenges for your clients and requires taking some steps to meet those challenges, including managing liquidity, maintaining and improving their controls and risk management, and providing increased transparency to investors through financial statement disclosures. Included in the following are some considerations for your clients. For more information to assist the financial statement preparers, the AICPA is developing a Financial Reporting Alert as a companion publication to this alert.

Managing Risk

.104 Given the events of 2008, entities should ensure that counterparty risk has been minimized to the extent practicable. Some steps entities could take to achieve this goal include reassessing possible defaults of any significant counterparties, reviewing and examining the underlying collateral for all agreements that contain these requirements, assessing any changes in the creditworthiness of the counterparty, diversifying among counterparties, and if possible, creating cross-default clauses in debt agreements. The decline in financial institutions due to bankruptcy or consolidation may also negatively affect an entity’s ability to obtain favorable financing terms in addition to limiting the entity’s ability to diversify counterparty risk. Given the dramatic decline in the current market values of securities, entities should also consider reevaluating internally used valuation models to ensure that all current risk factors are appropriately incorporated.

.105 Other considerations include analyzing the amounts of recourse, nonrecourse, and unlevered financings to ensure an appropriate balance exists. Similarly, the total amount of leverage employed by an entity should be analyzed as it could be detrimental to the entity if investors or lenders view the ratio as too high. An entity should constantly monitor all covenants in order to prevent a violation before it happens. Lastly, an entity’s management might consider increasing lines of credits or exploring other measures to ensure any future requirements for liquidity can be met.
With the constant news of lay-offs and companies scaling back spending, management should try to strike a balance between curtailing spending and maintaining a robust risk management process. With the expected continued risks and uncertainties facing our economy, a strong risk management process will be a vital asset in maintaining an entity’s financial health.

Given the sharp declines in many entities stock prices and debt securities, some entities are considering repurchasing these assets. This action can also boost investor confidence. To implement any repurchases, entities must ensure that they are authorized to take such measures and obtain any necessary approvals from the board of directors. Entities should also consider any tax and debt covenant implications of such repurchases. When making future decisions regarding liquidity needs, entities should also consider necessary contributions to pension plans.

**Internal Control and Processes**

Another area on which entities should focus during this economic period is controls. Many entities, in an attempt to prevent another crisis, are developing process controls that help them better understand their potential downside at any given point. Other possibilities include creating processes and controls within those processes to foster greater executive involvement and oversight. Entities are also implementing controls via human capital or software that more effectively capture the risk of an investment. Many have noted part of the problem that led to this economic crisis was the lack of understanding of investments owned and how greatly they could be affected by changes in the market. By having a firm-wide understanding of all assets owned, entities will more effectively be able to manage their risk and reduce the impact of the next economic storm that strikes.

Entities that invest heavily in financial assets and liabilities that are accounted for at fair value under FASB Statement No. 157 should consider implementing a controlled process and related policies for how to determine these measurements. As discussed by the Rothstein Kass article *SFAS 157 Fair Value Measurements: Implementation Challenges for the Alternative Investment Industry*, some items for inclusion might be the following:

Methodology on level designation, definition of an active market, the level of average trading volume and frequency that will deem a position as thinly traded (i.e., inactive)..., determination of the principal and/or most advantageous market, identifying aftermarket events and their impact on fair value, quantitative and qualitative documentation on the valuation techniques used, including how they fit into the fair value hierarchy, evaluating the effect of security restrictions, identifying risk assumptions in unobservable inputs, identifying the reports that will provide the required data to prepare the year-end financial statement disclosures..., [and] back testing of realized transactions.

**Disclosures**

In this current economic climate, both investors and regulators will be looking for increased disclosures in financial statements. Entities should review prior disclosures to be included in the current periods financial statements to determine if they are still appropriate and not misleading based on the current environment. Entities should also consider the effects of and disclosures of events that occurred after the balance sheet date. Some specific topics entities should consider expanding disclosures on include, but are not limited to, liquidity and capital resources, material impairments, pension plan assets, fair value determinations, critical accounting policies and estimates, risk factors, and relationships with distressed businesses. Another area to consider discussing is the entity’s strategy in dealing with current market conditions in addition to how it has been and will continue to be affected by the economic crisis.

In March and September 2008, the SEC sent illustrative letters to certain public companies identifying numerous disclosures on the application of FASB Statement No. 157 the entity may include in their managements discussion and analysis. Although the letters were sent only to financial institutions, the SEC has indicated that the letters apply to other organizations as well. The advice focused primarily on fair value measurements based on unobservable inputs, which require significant judgment and can have a
material effect on the results of an entity’s operations, liquidity, and capital resources. These letters can be obtained from the SEC’s Web site at www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm and www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm.

.112 Additionally, as described in AICPA Statement of Position (SOP) 94-6, Disclosure of Certain Significant Risks and Uncertainties (AICPA, Technical Practice Aids, ACC sec. 10,640), disclosure regarding an estimate should be made when known information available prior to issuance of the financial statements indicates that both of the following criteria are met:

- It is at least reasonably possible (more than remote but less than likely) that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events
- The effect of the change would be material to the financial statements.

Audit and Attestation Issues and Developments
Understanding the Entity and Its Environment and Performing Audit Procedures in Response to Assessed Risks

.113 AU section 314, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (AICPA, Professional Standards, vol. 1), establishes requirements and provides guidance about implementing the second standard of field work, as follows: “The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.” Obtaining this understanding is further complicated by the rapidly changing economic environment. In accordance with paragraph .04, the auditors primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures.

.114 The auditors understanding of the entity and its environment consists of an understanding of the following: (a) industry, regulatory, and other external factors, (b) nature of the entity, (c) objectives and strategies and the related business risks that may result in a material misstatement of the financial statements, (d) measurement and review of the entity’s financial performance, and (e) internal control, which includes the selection and application of accounting policies. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity’s ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the handling of the entity’s business is also dynamic, and the entity’s strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.115 Appendix A of AU section 314 contains examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to categories (a)—(d) of the preceding. Understanding the effects of the current economic climate on each specific audit client is a key step in designing the audit plan.

.116 AU section 318, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (AICPA, Professional Standards, vol. 1), provides guidance about implementing the third standard of field work, as follows: “The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.” To reduce audit risk to an acceptably low level, the auditor (a) should determine overall responses to address the assessed risks of material misstatement at the financial statement level and (b)
should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. The purpose is to provide a clear linkage between the nature, timing, and extent of the auditors further audit procedures and the assessed risks.

Audit Risks Arising From Current Economic Conditions

.117 The overall responses to manage assessed risks and the nature, timing, and extent of the further audit procedures to be performed are matters for the professional judgment of the auditor. In accordance with paragraph .75 of AU section 318, while performing the substantive procedures, some factors to assist the auditor in determining the sufficiency of the audit evidence include

- significance of the potential misstatement in the relevant assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements.
- effectiveness of managements responses and controls to address the risks.
- experience gained during previous audits with respect to similar potential misstatements.
- results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.
- source and reliability of available information.
- persuasiveness of the audit evidence.
- understanding of the entity and its environment, including its internal control.

.118 The recent economic conditions and regulatory actions described in this alert may cause additional risk factors that had not previously existed or did not have a material effect on audit clients in prior years. Some examples that may result from the current economic condition are as follows: constraints on the availability of capital and credit, going concern and liquidity issues, marginally achieving explicitly stated strategic objectives, use of off-balance-sheet financings, special-purpose entities and other complex financing arrangements, volatile real estate markets, and the credit crisis, which result in significant measurement uncertainty, including accounting estimates and fair value measurements, and operations that are exposed to volatile markets.

.119 Although many of these risks are not new to businesses, consideration of the many ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks. As noted in paragraph .17 of AU section 312, Audit Risk and Materiality in Conducting an Audit (AICPA, Professional Standards, vol. 1), some possible audit responses to a significant risk of material misstatement include increasing the extent of audit procedures, performing procedures closer to year-end, or increasing audit procedures to obtain more persuasive evidence. Additionally, given the constant changing status of economic conditions that could affect your client, auditors should consider modifying audit procedures to ensure that risks are still addressed adequately.

.120 Public float of many entities has significantly decreased due to the steep declines in stock prices. Under the amended exit provisions, an accelerated filer (large or otherwise) whose public float falls below $50 million as of the last business day of its second fiscal quarter would become a nonaccelerated filer for that fiscal year. This has caused some entities that were previously accelerated filers under SEC rules to become nonaccelerated filers. Based on the discussion document from the SEC Regulations Committee meeting on September 26, 2006, an issuer that exits accelerated filer status and becomes a nonaccelerated filer is not required to comply with Section 404(b) for a fiscal year ending before December 15, 2009. Section 404(b) is the auditors attestation on the effectiveness of internal control over financial reporting. The full discussion document can be found at www.aicpa.org/cpcaf/download/DocumentA_404_Reptg_by_Non_Acc_Filers_092606.pdf.
Liquidity Considerations

.121 In the AICPA’s recently issued TIS section on liquidity, some considerations for auditors are discussed in addition to the accounting considerations previously discussed in the “Accounting Issues and Developments” section of this alert. Auditors should consider whether any additional disclosures made by management include “forward-looking statements that are not required by generally accepted accounting principles and therefore may not be audited.” Auditors should also consider whether the inability to withdraw funds can pose significant challenges to the entity’s liquidity and therefore affect the entity’s ability to continue as a going concern. Restrictions on liquidity may also be an appropriate matter to communicate to those charged with governance. Lastly, the auditor should consider if he or she wishes to emphasize any liquidity restrictions in the auditors report.

Alternative Investments

.122 Another source of information for auditors is the AICPA’s practice aid Alternative Investments—Audit Considerations. This nonauthoritative practice aid focuses on the existence and valuation assertions associated with alternative investments, but also discusses general considerations pertaining to auditing alternative investments, management representations, disclosure of certain significant risks and uncertainties, and reporting. As defined in the foreword of the practice aid, alternative investments are “investments for which a readily determinable fair value does not exist...including private investment funds meeting the definition of an investment company...such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as bank common/collective trust funds.” The full text of this practice aid can be located on the AICPA’s Web site at www.aicpa.org/download/members/div/auditstd/Alternative_Investments_Practice_Aid.pdf.

.123 Further, as discussed in a meeting of the FASBs Valuation Resource Group, net asset value of a fund may not represent fair value under FASB Statement No. 157. Given the state of the economy many funds are imposing limitations on redemptions and some are even unwinding. As this occurs, the fair value measurements applied to these investments will fall under increased scrutiny and become even more important.

Auditing Fair Value Measurements

.124 In addition to understanding the looming questions relative to fair value accounting, auditors should be aware of audit issues involving fair value accounting. Particular assets, liabilities, and components of equity are measured or disclosed at fair value in the financial statements, and it is management’s responsibility to make the fair value measurements and disclosures. When auditing these fair values to ensure they are in conformity with GAAP, auditors should consult AU section 328, Auditing Fair Value Measurements and Disclosures (AICPA, Professional Standards, vol. 1), which establishes standards and provides guidance for auditors. Specific types of fair value measurements are not covered by AU section 328. For example, when auditing the fair value of derivatives and securities, refer to AU section 332, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities (AICPA, Professional Standards, vol. 1).

.125 In regard to analyzing the sufficiency of the audit evidence, the strongest audit evidence to support a fair value is an observable market price in an active market. If that is not available, a valuation method should incorporate common market assumptions. If common market assumptions are not available or require significant adjustments, the entity may use its own assumptions. The auditor should obtain an understanding of the entity’s process for determining fair values, as well as whether the fair value measurements and disclosures are in accordance with GAAP. During this testing, the auditor may also identify any possible indicators of impairment. According to paragraph .23 of AU section 328, “substantive tests of the fair value measurements may involve (a) testing managements significant assumptions, the valuation model, and the underlying data, (b) developing independent fair value estimates for corroborative purposes, or (c) reviewing subsequent events and transactions.” Paragraph .26 also notes when testing the fair value measurements and disclosures, the auditor evaluates whether managements assumptions are reasonable and reflect market information, or are not consistent with market information. In relation to FASB
Statement No. 157 this might include whether the market is distressed, whether the transaction was an orderly transaction, the reasonableness of the determination within the fair value hierarchy of inputs, and the reasonableness of the underlying assumptions.

**Fair Values of Securities**

.126 The guidance in AU section 332 relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, there are some items of note for the auditor. As previously mentioned, quoted market prices in active markets are the best available audit evidence to support a fair value. However, when they are unavailable and the valuations of securities are obtained from a broker or dealer or another pricing service based on valuation models, the auditor should understand the underlying valuation method used (such as a cash flow projection). These prices may also be based on quoted prices from an active market or other observable inputs that will be a consideration on the auditors procedures as well. The process used by the pricing service in measuring fair value should be evaluated to determine the consistency with the specified valuation method (typically fair value as defined in FASB Statement No. 157). The auditor may also determine it is necessary to obtain quotes from more than one pricing source based on circumstances such as an existing relationship between the entity and the valuing entity, which could inhibit objective pricing or underlying valuation assumptions that are highly subjective. In the context of FASB Statement No. 157 quoted prices in active markets are considered level 1 inputs.

.127 When an entity performs its own valuation, possible value testing procedures to be taken by the auditor include assessing the reasonableness, comparing the assumptions to industry reports or benchmarks, the appropriateness of the model, calculating the value using his or her own model, and comparing the fair value with subsequent or recent transactions. Whether the inputs to the entity’s valuation model are observable or not determines their characterization as level 2 or level 3 inputs, respectively, within FASB Statement No. 157. When there is extensive judgment, consider using a specialist or refer to AU section 342, *Auditing Accounting Estimates* (AICPA, Professional Standards, vol. 1). Additionally, when the underlying collateral of a security significantly contributes to its fair value and collectability of the security, evidence of the collateral should also be examined for existence, fair value, transferability, and the investors right to the collateral.

.128 Paragraph .19 of AU section 328 also notes, “The auditor should also evaluate whether the entity’s method for determining fair value measurements is applied consistently and if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the entity, or changes in accounting principles.”

.129 The auditor should also evaluate managements conclusions regarding other-than-temporary impairment on its securities. Examples of factors that could cause an other-than-temporary impairment per paragraph .47 of AU section 332 include the following:

- “Fair value is significantly below cost and
  - The decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
  - The decline has existed for an extended period of time.
  - Management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

- The security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
- The entity recorded losses from the security subsequent to the end of the reporting period.”
These factors are consistent with those discussed in the “Auditing Fair Value Measurements” section of this alert. Auditors must consider all facts and circumstances when determining if an other-than-temporary impairment has occurred. Additionally, the classification of an entity’s securities is based on management’s intent and ability. The auditor should obtain an understanding of management’s classification process between trading, available-for-sale, and held-to-maturity, as well as consider the classifications in light of the entity’s current financial position.

**Auditing Accounting Estimates**

As noted in paragraph .04 of AU section 342, the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as whole. Although this alert has discussed at length fair value measurements, it is important to remember there are many types of accounting estimates that exist in client financial statements. Some examples include the allowance for uncollectible accounts receivable, impairment analysis and estimated useful lives of long-lived assets, valuation allowance for deferred tax assets, and actuarial assumptions in pension and other postretirement benefit costs. Given the current economic climate, additional skepticism should be exercised when considering management’s underlying assumptions used in accounting estimates. When evaluating accounting estimates, the auditor should consider, with professional skepticism, both the subjective and objective factors. As discussed in paragraph .09 of AU section 342, key factors and assumptions the auditor normally concentrates on include which assumptions are significant to the estimate, sensitive to variations, deviate from historical patterns, or are particularly subjective and susceptible to misstatement and bias. However, it is important to consider whether historical patterns are still applicable. For example, in a slow market, new patterns may emerge. A key aspect of AU section 342 in this economy is for an auditor to determine the reasonableness of management’s accounting estimates with an extra degree of professional skepticism given the current economic climate and possible increases of pressure on management to meet earnings. As noted by AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), when assessing audit differences between client estimates and audit estimates, even if they are individually reasonable, an auditor should consider whether these differences are indicative of possible bias by management. If so, the auditor should reconsider the estimates taken as a whole.

The auditor should obtain an understanding of how management develops estimates and should employ one of the approaches in testing that process as outlined in AU section 342 paragraph .10. In reviewing and testing management’s process, the auditor may consider identifying controls around this process and determining if the underlying data used for the estimate are reliable and used appropriately. An auditor may also develop an estimate and compare it to management. Lastly, the auditor may review subsequent events or transactions occurring prior to the date of the auditor’s report. Further, as noted in AU section 316, hindsight may provide the auditor additional insight into the existence of management bias. For further details on auditing estimates, see AU section 342.

Additionally, AICPA SOP 94-6 describes required disclosures regarding estimates when certain information is known before issuance of the financial statements.

**Using the Work of a Specialist**

It may be necessary to use a specialist (such as a securities valuation expert) to assist in auditing complex or subjective matters during the audit. Examples of matters where an auditor may engage a specialist are valuation issues, reasonableness of determination of amounts derived from specialized techniques or models, or implementation of technical requirements, regulations, or legal documents. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance to auditors in using specialists. The guidance in AU section 336 is applicable when the specialist is hired by management or if the auditor engages the specialist. However, if a specialist employed by the auditor’s firm participates in the audit, AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), is applicable rather than AU section 336.
.135 When using the work of a specialist, the auditor should evaluate the specialist's professional qualifications, obtain an understanding of the nature of the work performed or to be performed, and evaluate the relationship of the specialist to the client in terms of objectivity. Although the appropriateness and reasonableness of the methods and assumptions employed by the specialist are his or her responsibility, the auditor should obtain an understanding of these qualities, test the underlying data provided to the specialist, and evaluate the specialist's findings in the context of the audit and related assertions in the financial statements.

Consideration of an Entity's Ability to Continue as a Going Concern

.136 The consideration of an entity’s ability to continue as a going concern is required in every audit performed under generally accepted auditing standards, and is an especially important consideration in the current state of the economy. An entity’s ability to continue as a going concern is affected by many factors related to the current uncertain economy—the industry and geographic area in which it operates, the financial health of its customers, suppliers, and financing sources. Accordingly, it is critical to perform an individual analysis of going concern issues related to each entity. The consideration of an entity’s ability to continue as a going concern may be discussed during client retention procedures and also in the earliest stages of the audit in conjunction with gaining an understanding of the entity and its environment. As explained by AU section 341, The Auditors Consideration of an Entity’s Ability to Continue as a Going Concern (AICPA, Professional Standards, vol. 1), the auditors evaluation is based on relevant conditions that exist at or have occurred prior to the date of the auditors report. Therefore, this is an ongoing evaluation that extends through the date of the auditors report.

.137 The auditor is responsible for evaluating whether there is a substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time. AU section 341 notes that is a period not to exceed one year beyond the date of the financial statements being audited. Some examples of indications that there could be substantial doubt about the ability of the entity to continue as a going concern include, but are not limited to, the following:

- Negative trends such as negative cash flows from operating activities, recurring operating losses, working capital deficiencies, or lack of the ability to obtain additional financing
- Other indications of financial difficulties such as defaults on debt, debt covenants, or both; arrearages in dividends; the need to seek new sources of financing; or the disposal of substantial assets
- Inadequate capitalization
- Internal matters such as turnover in key management positions like CEO, CFO, and controller, or substantial dependence on the success of a particular investment or project
- Entrance into a new market for which the entity might not have the required expertise to successfully compete
- External matters such as market conditions

.138 Audit teams may find it useful to have preliminary discussions about going concern considerations during engagement planning meetings. However, as noted in AU section 341, it is not necessary to design audit procedures around specifically identifying the possibility of a going concern since results of typical audit procedures should illuminate any indicators. These procedures may consist of analytical procedures, review of subsequent events, review of compliance with financing agreements, review of board minutes, inquiry of legal counsel, and confirmation with related third parties of the details of arrangements to provide or maintain financial support.

.139 Some risks related to the current state of the economy that may influence an entity’s ability to continue as a going concern include the following:

- Lenders may be looking for ways to get out of lending relationships.
• Financial support of a related party may not be a feasible mitigating factor depending on the financial health of that related party.
• An entity's financial health could be significantly weakened if their suppliers or customers have been strongly affected by the economic crisis.
• Projections provided by entities based on historical data may not be reliable future predictions.
• Some entities may be hesitant to include informative and transparent going concern disclosures.

.140 Possible audit responses for each of these respective risks are as follows:
• Discuss with management their relationship with the lender and thoroughly review loan agreements.
• Determine the viability of the related party to provide financial support and review any formal documentation stating the details of this financial support.
• Obtain a strong understanding of the entity's customers and suppliers and for any major customer or supplier consider reviewing data supporting their financial health.
• Review the projections in detail and consider their reasonableness based upon current economic conditions.
• Consider whether financial statement users would consider the disclosures complete.

.141 If the auditor believes a substantial doubt on the entity’s ability to continue as a going concern exists, the next steps are to obtain management plans to mitigate the effect of such conditions and then assess the likelihood that these plans can be effectively implemented. Additionally, auditors may consider posing the following questions to help make their assessment on how likely management plans will be to successfully mitigate their going concern risk:
• What is the strategy for extending lines of credit or refinancing any debt coming due? Have there been any preliminary agreements or discussions?
• If negative operating trends exist, how does management plan on turning them around?
• If turnover of key personnel has occurred, what actions are being taken to replace these positions?
• What is the plan to maintain or increase the liquidity of your balance sheet?
• Are there any restrictions which could limit management's ability to carry out these plans?

.142 As noted in paragraph .08 of AU section 341, when evaluating management’s plans, the auditor should also identify those elements that are particularly significant to overcoming the adverse effects of the conditions and events and obtain audit evidence for these elements. For example, at the date of this writing, a condition that is significant to some entities ability to continue as a going concern is the success of the government bailout for U.S. automakers. This would affect not just the automakers, but also any supplier which heavily relies on the business of one of these U.S. automakers, in addition to the thousands of dealerships across the country.

.143 If an auditor determines there is a substantial doubt about an entity’s ability to continue as a going concern, the auditor should communicate with those charged with governance of the entity in accordance with AU section 341. In that instance, the auditor should also consider the effects on the entity’s financial statements and the adequacy of the related disclosure. The disclosure might include such information as the condition which gave rise to the doubt about the entity’s ability to continue as a going concern, management’s evaluation of the significance of those conditions and any mitigating factors, possible ceasing of operations, and management plans going forward. Alternatively, if management’s plan mitigates the risk of the entity’s ability to continue as a going concern, the auditor should consider disclosing the primary conditions that gave rise to the initial doubt and management plans. These disclosures are especially important for financial statement users to fully comprehend the entity’s financial strength and ability to continue as a going concern.
.144 If the auditor ultimately determines there is a substantial doubt about an entity’s ability to continue as a going concern, an explanatory paragraph should be added to the audit report following the opinion paragraph. AU section 341 provides an example explanatory paragraph.

.145 AU section 341 also provides further guidance to an auditor with respect to evaluating whether there is substantial doubt about an entity’s ability to continue as a going concern and what the auditor should do when such a doubt exists. FASB has undertaken a project that will relocate the guidance related to going concern from the realm of auditing standards to accounting standards. See the “On the Horizon” section of this alert for further details.

Consideration of Fraud in a Financial Statement Audit

.146 AU section 316 is the primary source of authoritative guidance about an auditors responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement (whether the material misstatement was caused by error or fraud as stated in paragraph .02 of AU section 110, Responsibilities and Functions of the Independent Auditor [AICPA, Professional Standards, vol. 1]).

.147 Three conditions generally are present when fraud occurs. First, management or other employees have an incentive or are under pressure, which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an opportunity for a fraud to be perpetrated. Third, those involved are able to rationalize committing a fraudulent act. The current economic situation may result in unexpected losses and possibly cause financing or liquidity difficulties for many entities. Additionally, management may be valuing many illiquid securities using inherently subjective methodologies. These situations may provide management additional opportunity and incentive to commit fraud.

.148 A recent fraud discussed in the news, which contains all 3 conditions for fraud to occur, has been that of Bernard Madoff Investment Securities. At the time of this writing, the owner of the investment firm, Bernard Madoff, has been charged with paying off earlier investors with money from new investors. This is a classic example of a Ponzi scheme, which demonstrated itself as markets began declining and many investors requested redemptions of their capital. The losses from this fraud are estimated at $50 billion. Although the details of this fraud are just beginning to be investigated, auditors should ensure they are properly testing for existence of assets, such as investments in this scenario.

.149 Additionally, auditors should always gain an understanding of the entity’s business and how profits are made. In this scenario, auditors are being probed about failing to question the strong, consistent annual returns by these investment funds that lacked a clear investment strategy. Because of the characteristics of fraud, the auditors exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditors belief about management’s honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. In accordance with paragraph .79 of AU section 316, any fraud involving senior management and any fraud that causes a material misstatement of the financial statements (regardless of the perpetrator) should be reported directly to those charged with governance.

.150 As further discussed in AU section 316, 3 ways for the auditor to respond to the risk of material misstatement due to fraud include

- a response involving more general considerations apart from specific audit procedures otherwise planned. For example, ensure that the knowledge and skill of the assigned personnel to the client engagement matches the risk of material misstatement due to fraud of the engagement.
a response to identified risks that involves the nature, timing, and extent of the auditing procedures to be performed. For example, ensure that the auditing procedures to address the risk of material misstatement due to fraud vary depending upon the level of risk, the account balance, the class of transactions, and the related assertions which may be affected.

a response involving the performance of certain procedures to further address the risk of material misstatements due to fraud involving management override of controls given the unpredictable ways this could occur. For example, examine journal entries and other adjustments or evaluate the business rationale for significant unusual transactions.

Management Letter of Representations

.151 As discussed in AU section 333, Management Representations (AICPA, Professional Standards, vol. 1), in some circumstances, audit evidence that can be obtained by the application of auditing procedures other than inquiry is limited; therefore, the auditor obtains written representations to provide additional audit evidence. This may be the case for assumptions used in fair value measurements or the entire measurement or claims around an entity’s ability to continue as a going concern.

.152 According to paragraph .48 of AU section 328, the auditor ordinarily should add language to the letter of representations from management regarding the reasonableness of significant underlying assumptions, including whether they appropriately reflect management’s intent and ability to carry out specific courses of action on behalf of the entity where relevant to the use of fair value measurements or disclosures. Additionally, depending on the nature, materiality, and complexity of fair values, representations may be included in regard to the appropriateness of the measurement methods and consistency in the application of these methods, the completeness and adequacy of disclosures related to fair values, and whether subsequent events require adjustment to the fair value measurements and disclosures included in the financial statements. When significant assumptions are used or they are highly subjective, and the items being measured at fair value are material, the auditor considers discussing these items with those charged with governance of the entity.

Communication With Those Charged With Governance

.153 In addition to instances where communication with those charged with governance in other auditing sections is discussed, there are other select measures outlined in AU section 380, The Auditor’s Communication With Those Charged With Governance (AICPA, Professional Standards, vol. 1), which are specifically relevant during an economic crisis and when measuring fair value. AU section 380 establishes standards and provides guidance on the auditors communication with those charged with governance. As noted in paragraph .05, “the auditor must communicate with those charged with governance matters related to the financial statement audit that are, in the auditors professional judgment, significant and relevant to the responsibilities of those charged with governance in overseeing the financial reporting process.”

.154 The auditor should communicate his or her views about the quality of the entity’s significant accounting policies, accounting estimates, and financial statement disclosures. As further described in appendix B of AU section 380, the communication regarding accounting policies may include the effect of any significant accounting policies in controversial or emerging areas. Regarding accounting estimates, the communication may include

• managements identification of accounting estimates.
• managements process for making accounting estimates.
• risks of material misstatement.
• indicators of possible management bias.
• disclosure of estimation uncertainty in the financial statements

.155 AU section 328 expands on the applicability of AU section 380 when auditing fair value measurements by noting the consideration of the auditor to communicate the nature of the significant
assumptions used in fair value measurements, the degree of subjectivity involved, and the materiality of the items being measured at fair value to the financial statements as a whole.

.156 AU section 341 expands on the applicability of AU section 380 when the auditor has concluded that substantial doubt about the entity’s ability to continue as a going concern exists. In that case, the auditor should communicate to those charged with governance: the nature of the events or conditions identified, the possible effect on the financial statements, the sufficiency of the related disclosures, and the effects on the auditors report.

.157 Additionally, unless all of those charged with governance are involved in managing the entity, the auditor should communicate the representations being requested from management.

.158 Although it is impossible to predict and include all accounting, auditing, and attestation issues that may affect your engagements we have covered primary areas of concern given the current economic conditions. Continue to remain alert to economic, legislative, and regulatory developments as well as the associated accounting, auditing, and attestation issues as you perform your engagements.

Recent Accounting, Auditing, and Attestation Pronouncements

.159 Presented in the following tables, for your convenience, are a list of recently issued accounting pronouncements and related guidance and a list of audit and attestation pronouncements and related guidance.

.160 For information on accounting, audit, and attestation standards issued subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued accounting standards in the CPA Letter and the Journal of Accountancy. Lastly, for announcements of newly issued auditing and attestation standards issued, please refer to the AICPA Accounting and Auditing Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing and to the quarterly electronic newsletter In Our Opinion, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion/.

Summary of Recent Accounting Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Recent Accounting Pronouncements and Related Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>FASB Statement No. 162 (May 2008)</td>
</tr>
<tr>
<td>FASB Statement No. 161 (March 2008)</td>
</tr>
<tr>
<td>FASB Statement No. 160 (December 2007)</td>
</tr>
<tr>
<td>FASB Statement No. 141 (revised 2007)</td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>Recent Accounting Pronouncements and Related Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FASB Statement No. 158</strong> (September 2006)</td>
</tr>
<tr>
<td><strong>FASB Statement No. 157</strong> (September 2006)</td>
</tr>
<tr>
<td><strong>FASB Interpretation No. (FIN) 48</strong> (June 2006)</td>
</tr>
<tr>
<td><strong>FASB Emerging Issues Task Force (EITF) Issues</strong></td>
</tr>
<tr>
<td>(Various dates)</td>
</tr>
<tr>
<td><strong>FASB Staff Positions</strong> (Various dates)</td>
</tr>
<tr>
<td><strong>AICPA Statement of Position (SOP) 07-1 (AICPA, Technical Practice Aids, ACC sec. 10,930)</strong></td>
</tr>
<tr>
<td><strong>Technical Questions and Answers</strong> (TIS) section 6300.36 (AICPA, Technical Practice Aids)</td>
</tr>
<tr>
<td>(Nonauthoritative)</td>
</tr>
<tr>
<td><strong>TIS section 9150.25 (AICPA, Technical Practice Aids)</strong></td>
</tr>
<tr>
<td>(Nonauthoritative)</td>
</tr>
</tbody>
</table>

(continued)
Recent Accounting Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>TIS section 1100.15 (AICPA, Technical Practice Aids) (Nonauthoritative)</th>
<th>“Liquidity Restrictions”</th>
</tr>
</thead>
<tbody>
<tr>
<td>This question and answer discusses auditing and accounting issues related to withdrawal restrictions placed on short term investments by a money market fund or its trustee.</td>
<td></td>
</tr>
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| TIS sections 6910.25–.28 (AICPA, Technical Practice Aids) (Nonauthoritative) | These questions and answers discuss financial statement presentation considerations for investment companies. |

| TIS sections 6140.20–.22 (AICPA, Technical Practice Aids) (Nonauthoritative) | These questions and answers discuss not-for-profit organizations fund-raising expenses. |

| TIS section 6931.08–.10 (AICPA, Technical Practice Aids) (Nonauthoritative) | These questions and answers discuss various employee benefit plan topics. |

| AICPA Practice Guide (Nonauthoritative) | Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48 |

Summary of Recent Auditing and Attestation Pronouncements and Related Guidance

.161 As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. The Public Company Accounting Oversight Board (PCAOB) establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review Audit Risk Alert SEC and PCAOB Developments—2008 (product no. 022499kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by visiting www.cpa2biz.com.

Recent Auditing and Attestation Pronouncements and Related Guidance

| Statement on Auditing Standards (SAS) No. 115, Communicating Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, vol. 1, AU sec. 325) (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS]) | Replacing SAS No. 112, Communicating Internal Control Related Matters Identified in an Audit, this standard defines the terms deficiency in internal control, significant deficiency and material weakness, provides guidance on evaluating the severity of deficiencies in internal control identified in an audit of financial statements, and requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit. It is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted. |
### Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>SAS No. 114, The Auditor’s Communication With Those Charged With Governance (AICPA, Professional Standards, vol. 1, AU sec. 380)</th>
<th>Replacing SAS No. 61, Communication With Audit Committees, this statement requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, to whom they should be communicated, and the form and timing of the communication. It is effective for audits of financial statements for periods beginning on or after December 15, 2006.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue Date: December 2006 (Applicable to audits conducted in accordance with GAAS)</td>
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<tr>
<td>SAS No. 113, Omnibus Statement on Auditing Standards—2006 (AICPA, Professional Standards, vol. 1)</td>
<td>This statement does the following:</td>
</tr>
<tr>
<td>Issue Date: November 2006 (Applicable to audits conducted in accordance with GAAS)</td>
<td>• Revises the terminology used in the 10 standards of AU section 150, Generally Accepted Auditing Standards, to reflect terminology in AU section 120, Defining Professional Requirements in Statements on Auditing Standards (AICPA, Professional Standards, vol. 1).</td>
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<td></td>
<td>• Adds a footnote to the headings before paragraphs .35 and .46 in AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), to provide a clear link between the auditors consideration of fraud and the auditors assessment of risk and the auditors procedures in response to those assessed risks.</td>
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<td></td>
<td>• Replaces throughout the SASs the term completion of fieldwork with the term date of the auditors report.</td>
</tr>
<tr>
<td></td>
<td>• Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditors report.</td>
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<tr>
<td>SAS Nos. 104–111, the risk assessment standards</td>
<td>The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits; focusing on identifying and assessing the risks of material misstatements; further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels; and improving the linkage between the risks, controls, audit procedures, and conclusions. These 8 SASs became effective for audits of financial statements for periods beginning on or after December 15, 2006.</td>
</tr>
<tr>
<td>Issue Date: March 2006 (Applicable to audits conducted in accordance with GAAS)</td>
<td></td>
</tr>
<tr>
<td>Statement on Standards for Attestation Engagements (SSAE) No. 15, An Examination of an Entity’s Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements (AICPA, Professional Standards, vol. 1, AT sec. 501)</td>
<td>This statement establishes requirements and provides guidance that applies when a practitioner is engaged to perform an examination of the design and operating effectiveness of an entity’s internal control over financial reporting (examination of internal control) that is integrated with an audit of financial statements (integrated audit). This SSAE is effective for integrated audits for periods ending on or after December 15, 2008. Earlier implementation is permitted.</td>
</tr>
<tr>
<td>Issue Date: October 2008</td>
<td>(continued)</td>
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</table>
Recent Auditing and Attestation Pronouncements and Related Guidance

SSAE No. 14, SSAE Hierarchy
(AICPA, Professional Standards, vol. 1, AT sec. 50)
Issue Date: November 2006

This statement identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in AT section 20, Defining Professional Requirements in Statements on Standards for Attestation Engagements (AICPA, Professional Standards, vol. 1). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.

Interpretation No. 14, “Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing,” of AU section 508, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1, AU sec. 9508 par. .56–.59)
Issue Date: March 2002
Revised Date: May 2008
(Interpretive publication)

This interpretation of AU section 508 addresses the application of AU section 508 in reporting on financial statements prepared in conformity with International Financial Reporting Standards (IFRS).

Issue Date: May 2008
(Interpretive publication)

This interpretation of AU section 508 addresses the application of AU section 508 in reporting on financial statements prepared in conformity with IFRS.

Issue Date: May 2008
(Interpretive publication)

This interpretation of AU section 534 addresses the application of AU section 534 in reporting on financial statements prepared in conformity with IFRS.
## Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Interpretation</th>
<th>Description</th>
<th>Issue Date</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interpretation No. 3, “Financial Statements Audited in Accordance With International Standards on Auditing,” of AU section 534 (AICPA, Professional Standards, vol. 1, AU sec. 9534 par. .09–.11)</td>
<td>This interpretation of AU section 534 addresses the application of AU section 534 in audits of financial statements prepared for use outside the United States.</td>
<td>May 2008</td>
<td>(Interpretive publication)</td>
</tr>
<tr>
<td>SOP 07-2, Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisers, or Other Service Providers (AICPA, Technical Practice Aids, AUD sec. 14,430)</td>
<td>This statement addresses the application of SSAEs primarily to examination engagements in which a practitioner reports on the suitability of the design and operating effectiveness of a service providers controls in achieving specified compliance control objectives. Examples of the service providers addressed by this SOP are investment advisers, custodians, transfer agents, administrators, and principal underwriters that provide services to investment companies, investment advisers, or other service providers.</td>
<td>October 2007</td>
<td>(Interpretive publication)</td>
</tr>
<tr>
<td>TPA TIS section 1100.15</td>
<td>This question and answer discusses auditing and accounting issues related to withdrawal restrictions placed on short term investments by a money market fund or its trustee.</td>
<td>October 2008</td>
<td>(Nonauthoritative)</td>
</tr>
</tbody>
</table>
| TIS sections 8200.05–.16 (AICPA, Technical Practice Aids) | These questions and answers in TIS section 8200, Internal Control, were developed in response to common questions received from members regarding the implementation of SAS Nos. 104–111. Some of the topics include:  
  - consideration of internal controls that are less formal or not documented by the client.  
  - whether the auditor may suggest improvements to a clients internal control.  
  - assessing inherent risk in relation to the consideration of control risk.  
  - the frequency of walkthroughs that are used as the basis for the auditors understanding of internal control.  
  - considerations in obtaining an understanding of, evaluating, and documenting controls that the auditor believes are nonexistent or ineffective.  
  - assessing control risk at the maximum level.  
  - considerations for developing a substantive audit strategy. | April and May 2008 | (Nonauthoritative) |
**Recent Auditing and Attestation Pronouncements and Related Guidance**

<table>
<thead>
<tr>
<th>Issuance</th>
<th>Description</th>
</tr>
</thead>
</table>
| **TIS section 9120.08, “Part of an Audit Performed in Accordance With International Standards on Auditing”** (AICPA, Technical Practice Aids)  
Issue Date: April 2008  
(Nonauthoritative) | This question and answer discusses the implications to the principal auditors report when part of an audit is conducted by other independent auditors in accordance with International Standards on Auditing or another country’s auditing standards. |
| **TIS section 9100.06, “The Effect of Obtaining the Management Representation Letter on Dating the Auditors Report”** (AICPA, Technical Practice Aids)  
Issue Date: May 2007  
(Nonauthoritative) | This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditors report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditors report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that it will sign the representation letter, without exception, on or before the date of the representations. |
| **TIS section 8350.01, “Current Year Audit Documentation Contained in the Permanent File”** (AICPA, Technical Practice Aids)  
Issue Date: May 2007  
(Nonauthoritative) | This question and answer discusses whether the provisions of AU section 339, Audit Documentation (AICPA, Professional Standards, vol. 1), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that AU section 339 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current years audit report. |
| **AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, Audit Confirmations** (AICPA, Technical Practice Aids, PA sec. 16,240)  
Revised: June 2007  
(Nonauthoritative) | This practice alert is a response to practitioners current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics. |
| **AICPA PITF PA 07-1, Dating of the Auditors Report and Related Practical Guidance** (AICPA, Technical Practice Aids, PA sec. 16,290)  
Issue Date: January 2007  
(Nonauthoritative) | This practice alert provides guidance regarding application of certain provisions of AU section 339, primarily related to dating the auditors report. |
| **PCAOB Auditing Standard No. 6, Evaluating Consistency of Financial Statements** (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)  
Issue Date: September 2008  
(Applicable to audits conducted in accordance with PCAOB standards) | This standard and its related amendments update the auditors responsibilities to evaluate and report on the consistency of a company’s financial statements and align the auditors responsibilities with FASB Statement No. 154, Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3. This standard also improves the auditor reporting requirements by clarifying that the auditors report should indicate whether an adjustment to previously issued financial statements results from a change in accounting principles or the correction of a misstatement.  
Auditing Standard No. 6 is effective November 15, 2008. |
Recent Auditing and Attestation Pronouncements and Related Guidance


Issue Date: July 2007

(Applicable to audits conducted in accordance with PCAOB standards)

This standard replaces the PCAOB’s previous internal control standard, Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements. This principles-based auditing standard is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company’s financial statements, and, at the same time, eliminate procedures that are unnecessary.

Auditing Standard No. 5 is required to be used by registered audit firms for all audits of internal control over financial reporting no later than for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted and encouraged.

**PCAOB Rule 3526, Communication with Audit Committees Concerning Independence (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”)**

Issue Date: August 2008

(Applicable to audits conducted in accordance with PCAOB standards)

Rule 3526 requires the registered public accounting firm to

- describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence;

- discuss with the audit committee of the issuer the potential effects of any relationships that could impact independence, should they be appointed as the issuer’s auditor; and

- document the substance of these discussions. These discussions should occur at least annually.

The board also adjusted the implementation schedule for Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”), as it applies to tax services. The board agreed not to apply Rule 3523 to tax services provided on or before December 31, 2008, when those services are provided during the audit period and are completed before the professional engagement period begins. The amendments to Rule 3523 became effective August 28, 2008. The remaining provisions of Rule 3526 became effective on September 30, 2008.

**PCAOB Rule 3525, Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”)**

Issue Date: July 2007

(Applicable to audits conducted in accordance with PCAOB standards)

This rule requires a registered public accounting firm that seeks preapproval of an issuer audit client’s audit committee to perform internal control-related nonaudit services that are not otherwise prohibited by the act or the rules of the SEC or the PCAOB to describe, in writing, to the audit committee the scope of the proposed service, discuss with the audit committee the potential effects of the proposed service on the firm’s independence, and document the substance of the firm’s discussion with the audit committee. These requirements parallel the auditor’s responsibility in seeking audit committee preapproval to perform tax services for an audit client under PCAOB Rule 3524, Audit Committee Pre-approval of Certain Tax Services (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”). This rule is effective for audits of fiscal years ending on or after November 15, 2007.

(continued)
<table>
<thead>
<tr>
<th>PCAOB Conforming Amendments to the Interim Auditing Standards (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)</th>
<th>In conjunction with the PCAOB’s adoption of Auditing Standard No. 6, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in appendix 2 of PCAOB Release No. 2008-001 at <a href="http://www.pcaob.org/Rules/Docket_023/PCAOB_Release_No._2008-001_-_Evaluating_Consistency.pdf">www.pcaob.org/Rules/Docket_023/PCAOB_Release_No._2008-001_-_Evaluating_Consistency.pdf</a>. Issue Date: November 15, 2008 (Applicable to audits conducted in accordance with PCAOB standards)</th>
</tr>
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<tbody>
<tr>
<td>PCAOB Conforming Amendments to the Interim Auditing Standards (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)</td>
<td>In conjunction with the PCAOB’s adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in appendix 3 of PCAOB Release No. 2007-005A at <a href="http://www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf">www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf</a>. These amendments are effective for audits of fiscal years ending on or after November 15, 2007, the same effective date of Auditing Standard No. 5. Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)</td>
</tr>
<tr>
<td>PCAOB Release No. 2007-001, Observations on Auditors Implementation of PCAOB Standards Relating to Auditors Responsibilities With Respect to Fraud (AICPA, PCAOB Standards and Related Rules, “Selected SEC-Approved PCAOB Releases”)</td>
<td>This release focuses on aspects of the PCAOBs interim auditing standards that address the auditors responsibility with respect to fraud, specifically AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, PCAOB Standards and Related Rules, PCAOB Standards, As Amended). This report does not change or propose to change any existing standard nor is the PCAOB providing any new interpretation of existing standards. Issue Date: January 2007 (Applicable to audits conducted in accordance with PCAOB standards)</td>
</tr>
</tbody>
</table>
| PCAOB Staff Questions and Answers, Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 100 par. .05) | Topics covered include the following:  
- The application of PCAOB Rule 3522(a), Tax Transactions (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”), when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm  
- Whether a public accounting firm can advise an audit client on the tax consequences of structuring a particular transaction  
- Whether a registered public accounting firms independence is affected by the IRSs subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in PCAOB Rule 3522(b)  
- Clarification that the auditor must evaluate whether a person is in a financial reporting oversight role at affiliates and not just the audit client itself  
- Clarification of the term other change in employment event as it relates to PCAOB Rule 3522(c) |
| Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards) |
**Recent Auditing and Attestation Pronouncements and Related Guidance**

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<tr>
<th>Description</th>
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<tr>
<td>PCAOB Staff Audit Practice Alert No. 2, Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 400 par. 02)</td>
<td>This practice alert highlights certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of generally accepted accounting principles that are particularly relevant to the current economic environment.</td>
</tr>
<tr>
<td>Issue Date: December 2007</td>
<td>Issue Date: December 2008</td>
</tr>
<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
</tr>
<tr>
<td>PCAOB Staff Audit Practice Alert No. 3</td>
<td>This practice alert is designed to assist auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis. The practice alert is addresses six main areas: overall audit considerations; auditing fair value measurements; auditing accounting estimates; auditing the adequacy of disclosures; auditor’s consideration of a company’s ability to continue as a going concern; and additional audit considerations for selected financial reporting areas.</td>
</tr>
<tr>
<td>Issue Date: December 2008</td>
<td>Issue Date: December 2008</td>
</tr>
<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
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**Recent AICPA Independence and Ethics Pronouncements**

.162 Audit Risk Alert Independence and Ethics Developments—2008 (product no. 022479kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

.163 One specific independence consideration to pay particular attention to in the current economic environment relates to appropriate client services. Your firm may not provide valuation services for a client if the results of the service would be material to the clients financial statements and the service involves a significant amount of subjectivity.

.164 This rule has one limited exception for valuation services. Valuation services performed for nonfinancial statement purposes may be provided if they otherwise meet the general requirements of Interpretation No. 101-3, “Performance of Nonattest Services,” under Rule 101, Independence (AICPA, Professional Standards, vol. 2, ET sec. 101 par. .05).

**On the Horizon**

.165 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance because of the current state of the economy. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.166 The following table lists the various standard setting bodies Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.
Auditing Pipeline—Issuers

.167 In October 2008, the PCAOB proposed 7 new auditing standards to update and supersede the current risk assessment standards, which will be available for comment through February 18, 2009. The PCAOB chairman noted the proposals demonstrate the view that the risk of fraud is a central part of the audit process and not a separate consideration. The proposed standards integrate the risk assessment standards with the standard for the audit of internal control over financial reporting. Many of the International Auditing and Assurance Standards Boards risk assessment standards were utilized in creating these proposed standards and efforts were made to reduce any unnecessary differences. These proposed standards each have a statement of objective for the auditor, which were loosely adapted from the International Auditing Standards. This is an example of the move in the United States from rules-based to principles-based accounting and auditing standards because these objectives do not state required outcomes. The 7 proposed standards are the following:

- Audit Risk in an Audit of Financial Statements
- Audit Planning and Supervision
- Identifying and Assessing Risks of Material Misstatement
- The Auditors Responses to the Risks of Material Misstatement
- Evaluating Audit Results
- Consideration of Materiality in Planning and Performing an Audit
- Audit Evidence

.168 As with any new auditing standard or amendment to a PCAOB standard, after adoption by the PCAOB the standards will be submitted to the SEC for approval.

.169 Guidance issued by the PCAOB is included in the section of this alert titled “Summary of Recent Auditing and Attestation Pronouncements and Related Guidance.” For more information regarding recent developments at both the SEC and PCAOB, readers may refer to Audit Risk Alert SEC and PCAOB Developments—2008 (product no. 022499kk).

Accounting Pipeline

.170 In December 2008, FASB added to the technical agenda a comprehensive project to address the complexity in existing standards of accounting and reporting for financial instruments, which will be undertaken jointly with the IASB. This comprehensive project comprises four short term projects, as follows:
a. Amendments to EITF Issue No. 99-20  
b. Disclosures about Certain Financial Instruments  
c. Recoveries of Other-Than-Temporary Impairments (Reversals)  
d. Embedded Credit Derivative Scope Exception

.171 At the time of this writing, exposure drafts on EITF Issue No. 99-20 and disclosures about certain financial instruments have been issued. Further, exposure drafts on recoveries of other-than-temporary impairments and embedded credit derivative scope exception are expected to be released in the first quarter of 2009. Some of these projects are expected to have effective dates applicable for 2008 calendar year end entities. Readers are encouraged to check the progress of these projects on the FASB Web site at www.fasb.org.

.172 In October 2008, FASB issued an exposure draft of a proposed statement on going concern. The comment deadline was December 8, 2008. Currently, as discussed in the “Audit and Attestation Issues and Developments” section, the guidance on going concern is covered in AU section 341 and not in accounting literature. As discussed in the exposure draft, “The Board believes that accounting guidance about the going concern assumption should be directed specifically to management of a reporting entity because management is responsible for preparing an entity’s financial statements and evaluating its ability to continue as a going concern.”

.173 This proposed statement exemplifies the convergence with International Financial Reporting Standards (IFRS) as the statement carries forward much of the guidance in AU section 341, yet changes portions of it to become consistent with its IFRS equivalent. The modifications are as follows:

• Extend, without limit, the horizon for going concern assessment from the prior one year time frame beyond the date of the financial statements being audited.

• Change the types of information to be considered in making the going concern assessment to be stated as “all available information about the future.”

• Require an entity to disclose when it does not present financial statements on a going concern basis.

.174 By avoiding any conflicting interpretations regarding the time horizon, this proposed statement also exemplifies the movement towards principles based standards from rules based standards. The AICPA formally commented on this exposure draft and that comment letter can be read at www.fasb.org/ocl/1650-100/53021.pdf. Readers are also encouraged to review the exposure draft of this standard on the FASB Web site.

.175 For a summary of significant accounting projects and pronouncements, including proposed FASB EITF issues and proposed FSPs, refer to the FASB Web site.

Resource Central

.176 The following are various resources that practitioners may find beneficial to their audit engagements.

Publications

.177 Practitioners may find the following publications useful. Choose the format best for you—online, print, or CD-ROM:

A common set of high quality global standards remains the long-term strategic priority of both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board. For more information on the status of this project, go to www.fasb.org and www.iasb.org. The AICPA is calling for an orderly transition and reasonable time frame of three to five years for the U.S. accounting profession to adopt International Financial Reporting Standards.

Also visit the FASB Web site for updates regarding the FASB Accounting Standards Codification, which is expected to become effective in July 2009.
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2008) (product no. 012528kk [paperback], WDI-XXkk [online], or DDI-XXkk [CD-ROM])
- Audit Risk Alert *Independence and Ethics Developments—2008* (product no. 022479kk [paperback], WIA-XXkk [online], or DIA-XXkk [CD-ROM])
- Audit Risk Alert *SEC and PCAOB Developments—2008* (product no. 022499kk [paperback])
- Checklists and Illustrative Financial Statements for Corporations (product no. 008939kk [paperback] or WCP-CLkk [online])
- *Audit and Accounting Manual* (2008) (product no. 005138kk [paperback], WAM-XXkk [online], or AAM-XXkk [loose leaf])
- *Accounting Trends & Techniques, 62nd Edition* (product no. 009900kk [paperback] or WAT-XXkk [online])

**AICPA reSOURCE: Accounting and Auditing Literature**

.178 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm’s needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to the AICPA’s latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides (more than 20), Audit Risk Alerts (more than 15), and *Accounting Trends & Techniques*. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

**Continuing Professional Education**

.179 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA’s Annual Accounting and Auditing Update Workshop (2008–2009 Edition)* (product no. 736184kk [text] or 187192kk [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.

- *SEC Reporting* (product no. 736775kk [text] or 186756kk [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.

- *International Versus U.S. Accounting: What in the World is the Difference?* (product no. 731666kk [text]). With the fast pace of the convergence project, understanding the differences between IFRS and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRS and U.S. GAAP.

- *The International Financial Reporting Standards: An Overview* (product no. 157220kk [online] or 739750HSkk [DVD]). This course captures a live presentation on IFRS given to the AICPA Board of Directors.

.180 Among the many courses, the following are specifically related to the current economic conditions and to discussions on fair value and are useful for both members of business and industry and auditors:

- *Minimize the Effects of a Recession on Your Business* (182010kk [DVD and manual] and 352010kk [additional text and manual for DVD]). An economic slowdown may be an inevitable part of the business cycle, but its painful impact does not have to be same for every business. This course provides the information and guidance you need to weather a recession and build a stronger business over the long haul.

- *Plug Your Profit Leaks: Ways to Significantly Save Time and Money* (product no. 733820kk [text]). This course gives you specific ways to immediately affect an organization’s bottom line. These proven
techniques for plugging the most overlooked profit leaks come from specific strategies for lowering costs, improving productivity, or gaining efficiencies.

- **Lean Accounting and Management: Improving Profitability by Streamlining Operations** (product no. 731275kk [text]). Learn how to minimize waste and create wealth in your organization through a lean accounting and management approach that improves profitability by streamlining operations. Develop an action plan for accomplishing the transition to this lean accounting and management approach within your organization.

- **Fair Value Accounting: A Critical New Skill for All CPAs** (product no. 733301kk [text] or 183301kk [DVD and manual] and 353301kk [additional manual for DVD]). The course covers the conceptual and practical issues that arise when fair value measurement is implemented under existing FASB standards and provides examples of these issues.

Visit www.cpa2biz.com for a complete list of CPE courses.

**Online CPE**

.181 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz, is AICPA’s flagship online learning product. AICPA members pay $180 for a new subscription and $149 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest include the following:

- Accounting & Auditing Quarterly Updates
- Accounting & Auditing Annual Updates
- Auditor Communications: Critical New Requirements
- Fair Value Accounting: A Critical New Skill for All CPAs
- Bottom Line Management Accounting: Practical Solutions to Real World Problems
- Plug Your Profit Leaks: Ways to Significantly Save Time and Money
- Controllers: AICPAs Annual Update
- Lean Accounting
- Lean Management

To register or learn more, visit www.cpa2biz.com.

**Webcasts**

.182 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the professions leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.

**CFO Quarterly Roundtable Series**

.183 The CFO Quarterly Roundtable Series, brought to you each calendar quarter via webcast, covers a broad array of “hot topics” that successful organizations employ and subjects that are important to the CFOs personal success. From financial reporting, budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.
SEC Quarterly Update Series

The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the professions leading experts on what is “hot” at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you “plugged in” to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

IFRS Quarterly Webcast Series

The IFRS Quarterly Webcast Series, brought to you each calendar quarter is part of a multistep educational process to get practitioners, financial managers, and auditors up to speed on all aspects of IFRS implementation. Over the course of the quarterly series, IFRS standards will be covered in depth. International harmonization is quickly approaching and this series will help both accountants and auditors stay abreast of the developments and the changes they will need to implement.

Member Service Center

To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA’s Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. Beginning January 14, 2008, hotline hours were extended so that the hotline is now available from 9 a.m. to 8 p.m. on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/.

Ethics Hotline

In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA’s Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077.

Conferences

The AICPA offers a number of conferences that include the most recent developments affecting the profession. The AICPA has two such opportunities relative to fair value.

The AICPA is offering a Fair Value Measurement Workshop in February 2009. The Fair Value Measurement Workshop is a 2 day workshop with an objective of discussing the conceptual issues in using fair value measurements and providing examples of valuation measurements. This workshop will provide detailed examples of measuring the fair value of individual assets, especially as prepared by a valuation specialist. The workshop will show members in industry as well as their outside auditing firms the information necessary to confront the challenges in making and attesting to fair value measurements.

Additionally, the AICPA is offering a Fair Value Measurement Conference in June 2009. The Fair Value Measurement Conference is a 2-day conference designed to offer you specialized knowledge pertinent to your area of focus. With 3 distinct tracks—auditing, valuation, specialized knowledge—experts
from the field will share knowledge and update you on several key fair value measurement initiatives and regulations. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

The Center for Audit Quality

.192 The CAQ was created to serve investors, public company auditors, and the markets. The CAQs mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the professions core values of integrity, objectivity, honesty, and trust.

.193 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit http://thecaq.aicpa.org.

* * * *

.194 We hope you find this alert helpful as you perform your audit engagements. We would greatly appreciate your feedback on this Audit Risk Alert. You may e-mail these comments to klchtenstein@aicpa.org or write to

Keira A. Lichtenstein, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110
Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

<table>
<thead>
<tr>
<th>Web Site Name</th>
<th>Content</th>
<th>Web Site</th>
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</thead>
<tbody>
<tr>
<td>American Institute of CPAs (AICPA)</td>
<td>Summaries of recent auditing and other professional standards as well as other AICPA activities</td>
<td><a href="http://www.aicpa.org">www.aicpa.org</a></td>
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<td><a href="http://www.cpa2biz.com">www.cpa2biz.com</a></td>
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<td><a href="http://www.ifrs.com">www.ifrs.com</a></td>
</tr>
<tr>
<td>AICPA Accounting Standards Executive Committee (AcSEC)</td>
<td>Issues guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things</td>
<td><a href="http://www.aicpa.org/Professional+">www.aicpa.org/Professional+</a> Resources/Accounting+and+Auditing/Accounting+Standards</td>
</tr>
<tr>
<td>AICPA Accounting and Review Services Committee (ARSC)</td>
<td>Develops and issues review and compilation standards and interpretations</td>
<td><a href="http://www.aicpa.org/Professional+">www.aicpa.org/Professional+</a> Resources/Accounting+and+Auditing/ Audit+and+Attest+Standards/ Accounting+and+Review+Services+Committee</td>
</tr>
<tr>
<td>AICPA Professional Issues Task Force (PITF)</td>
<td>Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts</td>
<td><a href="http://www.aicpa.org/Professional+">www.aicpa.org/Professional+</a> Resources/Accounting+and+Auditing/ Audit+and+Attest+Standards/ Professional+Issues+Task+Force</td>
</tr>
<tr>
<td>Economy.com</td>
<td>Source for analyses, data, forecasts, and information on the United States and world economies</td>
<td><a href="http://www.economy.com">www.economy.com</a></td>
</tr>
<tr>
<td>The Federal Reserve Board</td>
<td>Key interest rates</td>
<td><a href="http://www.federalreserve.gov">www.federalreserve.gov</a></td>
</tr>
<tr>
<td>Financial Accounting Standards Board (FASB)</td>
<td>Summaries of recent accounting pronouncements and other FASB activities</td>
<td><a href="http://www.fasb.org">www.fasb.org</a></td>
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<tr>
<td>International Accounting Standards Board (IASB)</td>
<td>Summaries of International Financial Reporting Standards and International Accounting Standards</td>
<td><a href="http://www.iasb.org">www.iasb.org</a></td>
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<td>International Auditing and Assurance Standards Board (IAASB)</td>
<td>Summaries of International Standards on Auditing</td>
<td><a href="http://www.iaasb.org">www.iaasb.org</a></td>
</tr>
<tr>
<td>International Federation of Accountants (IFAC)</td>
<td>Information on standards setting activities in the international arena</td>
<td><a href="http://www.ifac.org">www.ifac.org</a></td>
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<tr>
<td><strong>Web Site Name</strong></td>
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<tr>
<td>Private Company Financial Reporting Committee (PCFRC)</td>
<td>Information on the initiative to further improve FASB’s standard setting process to consider needs of private companies and their constituents of financial reporting.</td>
<td><a href="http://www.pcfrc.org">www.pcfrc.org</a></td>
</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
<td>Information on accounting and auditing activities of the PCAOB and other matters</td>
<td><a href="http://www.pcaob.org">www.pcaob.org</a></td>
</tr>
<tr>
<td>USA.gov</td>
<td>Portal through which all government agencies can be accessed</td>
<td><a href="http://www.usa.gov">www.usa.gov</a></td>
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[The next page is 8071.]
AAM Section 8015

Compilation and Review Developments—2008

CURRENT ACCOUNTING REPORTING AND PRACTICE ISSUES

Notice to Readers

This Compilation and Review Alert is intended to provide accountants with an update on recent practice issues and professional standards that affect compilation and review engagements.

This publication is an other compilation and review publication as defined in AR section 50, Standards for Accounting and Review Services (AICPA, Professional Standards, vol. 2). Other compilation and review publications have no authoritative status; however, they may help the accountant understand and apply the Statements on Standards for Accounting and Review Services.

If an accountant applies the guidance included in an other compilation and review publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the engagement and appropriate. The guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Kristy L. Illuzzi, CPA
Technical Manager
Accounting and Auditing Publications

Acknowledgments

The Accounting and Auditing Publications Team would like to thank the members of the Accounting and Review Services Committee for their invaluable review of this year’s publication. We would also like to thank the AICPA Peer Review program for their contributions to this publication. In addition, the AICPA staff is grateful to Mike Glynn, CPA, Technical Manager, Audit and Attest Standards for his essential contributions in creating this publication.

How This Alert Helps You

.01 This Compilation and Review Alert (alert) is a crucial tool, designed to help you as you plan and perform your compilation and review engagements. This alert discusses recent Standards for Accounting and Review Services (SSARSs) developments, addresses emerging practice issues, points out pitfalls that frequently occur in compilation and review engagements, and provides valuable information regarding current accounting developments.

Economic Developments

The State of the Economy

.02 When compiling or reviewing financial statements, you should possess a level of knowledge of the accounting principles and practices of the industry in which the entity operates that will enable you to compile or review the financial statements for an entity operating in that industry. Furthermore, to compile or review financial statements, you should possess a general understanding of the nature of the entity’s business transactions. Such understanding may include an understanding of the economic conditions facing the industry in which your client operates. Economic activities relating to factors such as interest rates,
consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on your client.

.03 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.2 percent in 2007. According to 2008 second quarter advance estimates, real GDP increased at an annual rate of 1.9 percent, which is up slightly from the 1.0 percent rate in the first quarter of 2008.

.04 The unemployment rate remained relatively unchanged during 2007, holding between 4.4 percent and 5.0 percent, with an annual average rate of 4.6 percent. However, during 2008, the unemployment rate has risen. As of July 2008, the unemployment rate was 5.7 percent, representing approximately 8.8 million people.

.05 The target for the federal funds rate remained stable at 5.25 percent from June 2006 to September 2007 when the Federal Reserve began decreasing rates. Since the first rate decrease in September 2007, the Federal Reserve has decreased rates a total of 3.25 percentage points to 2.00 percent as of the end of July 2008. The Federal Reserve noted in its July press release that overall economic activity continues to expand. However, labor markets have softened further, and financial markets remain under considerable stress. Tight credit conditions, the ongoing housing contraction, and the rise in energy prices are likely to weigh on economic growth over the next few quarters. Inflation has been high, spurred by the earlier increases in the prices of energy and some other commodities, and some indicators of inflation expectations have been elevated. The Federal Open Market Committee expects inflation to moderate later this year and next year, but the inflation outlook remains highly uncertain.

Small Business Trends and Conditions

.06 Private companies and, more specifically, small businesses, are a main driver for the United States economy. According to the National Federation of Independent Businesses, small business has produced roughly half of the private gross domestic product and about two out of every three net new jobs in the United States since the early 1970s. The United States has nearly 6 million small business employers, 96 percent of which employ fewer than 100 people. Ninety-nine percent of employing businesses are “small” under prevailing definitions.

.07 Small businesses are represented in virtually every industry. However, the following are the most common among those that employ people other than their owners: retail; construction; professional; scientific; technical services; other services (generally, professional services like barber shops); health care and social assistance; accommodations and food service; wholesale; administrative support and waste management services; and manufacturing. The biggest change in the last 25 years has been the increase in service businesses and the decrease in retail businesses.

.08 In June 2008, Discover Business Card released the results of the Discover Small Business Watch, a monthly index of economic confidence of the nation’s 22 million small businesses with five or fewer employees. The Discover Small Business Watch (Watch) is compiled each month by Rasmussen Reports, LLC, an independent research firm, and is based on telephone interviews and responses from approximately 1,000 small business owners and 4,000 potential users of small business products and services.

.09 According to the Watch, after a brief rebound in May 2008, economic confidence among small business owners dropped to a record low in June 2008. The number of those who think the U.S. economy is getting worse expanded to nearly 80 percent. The Watch plummeted in June 2008 to 71.8, down 10 points from 81.8 in May 2008.

.10 Overall, the economic outlook remains uncertain. Pay close attention to how economic factors such as interest rates, consumer confidence, the housing market, overall economic expansion or contraction, inflation, and the labor market will affect your clients and your compilation and review engagements this year.
Recently Issued SSARSs

.11 The Accounting and Review Services Committee (ARSC) has approved an ambitious plan to make the standards for compilation and review engagements more understandable and easier to use. The first step in this process was the elimination of references to the auditing literature that existed within the SSARSs. The ARSC is aware that many more compilations and reviews are performed each year in the United States than audits. Furthermore, many practitioners who perform compilation and review engagements do not perform any audits. Therefore, the ARSC concluded that it is not appropriate to reference literature that many practitioners may be unfamiliar with. The ARSC developed and issued SSARS No. 15, Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services (AICPA, Professional Standards, vol. 2), which resulted in a SSARSs codification that stands alone as the source for standards on the performance and reporting for compilation and review engagements.

.12 The next step in the process of making the SSARSs more understandable was defining the use of the terms should and must within the standards. The ARSC accomplished this through the development and issuance of SSARS No. 16, Defining Professional Requirements in Statements on Standards for Accounting and Review Services (AICPA, Professional Standards, vol. 2, AR sec. 20). The final chapter in the trilogy is SSARS No. 17, Omnibus Statement on Standards for Accounting and Review Services—2008 (AICPA, Professional Standards, vol. 2). SSARS No. 17 further clarifies the standards for compilation and review engagements. The following provides a summary of SSARS Nos. 16 and 17.

Issuance of SSARS No. 16

.13 In December 2005, the Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 102, Defining Professional Requirements in Statements on Auditing Standards (AICPA, Professional Standards, vol. 1, AU sec. 120). SAS No. 102 expressly defined imperatives used to describe different degrees of the auditor’s responsibility when conducting audit engagements in accordance with generally accepted auditing standards. The ARSC believed that by defining the levels of responsibilities that accountants have in compilation and review engagements in a fashion similar to SAS No. 102, standards for compilation and review engagements would be clarified, and the imperatives used in such standards would then be consistent with the standards for audit engagements.

.14 Therefore, on December 18, 2007, the ARSC issued SSARS No. 16. SSARS No. 16 defines the terminology that the ARSC will use to describe the degrees of responsibility that the requirements impose on the accountant.

.15 SSARSs use two categories of professional requirements identified by specific terms to describe the degree of responsibility that they impose on accountants, which mirror the definitions in the auditing standards. They are as follows:

**Unconditional requirements.** The accountant is required to comply with an unconditional requirement in all cases in which the circumstances exist to which the unconditional requirement applies. SSARSs use the words must or is required to indicate an unconditional requirement.

**Presumptively mandatory requirements.** The accountant is also required to comply with a presumptively mandatory requirement in all cases in which the circumstances exist to which the presumptively mandatory requirement applies; however, in rare circumstances, the accountant may depart from a presumptively mandatory requirement provided that the accountant documents his or her justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement. SSARSs use the word should to indicate a presumptively mandatory requirement.

.16 If a SSARS provides that a procedure or action is one that the accountant “should consider,” the consideration of the procedure or action is presumptively required, whereas carrying out the procedure or action is not. The professional requirements of a SSARS are to be understood and applied in the context of the explanatory material that provides guidance for their application.
The ARSC believes that this clarity and consistency will assist accountants in their work and improve the quality of compilation and review engagements. SSARS No. 16 was effective upon issuance.

**Issuance of SSARS No. 17**

On February 13, 2008, the ARSC issued SSARS No. 17. This SSARS was intended to further clarify the standards for compilation and review engagements. This SSARS

- revises AR section 100, *Compilation and Review of Financial Statements*; AR section 200, *Reporting on Comparative Financial Statements*; and AR section 300, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (AICPA, *Professional Standards*, vol. 2), to conform to the terminology utilized by other standard setters, including the ASB, by replacing the term *nonpublic entity* with the term *nonissuer*. Generally, a *nonpublic entity* as defined before the issuance of SSARS No. 17 in AR section 100A paragraph .04, is considered a *nonissuer* under the revised definition in AR section 100 paragraph .04.

- revises the definition of compilation of financial statements and clarifies the objective of a compilation engagement as an engagement in which no assurance is provided and incorporating such objective in a new section of AR section 100 entitled, “Objective of a Compilation Engagement.” In addition, the illustrative engagement letter for a compilation of financial statements and the illustrative engagement letter for a compilation of financial statements not intended for third party use are revised to incorporate the stated objective. You can find the revised illustrative engagement letters at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee/Updated+Illustrative+Engagement+Letters+to+Reflect+SSARS+17+Changes.htm.

- revises the definition of review of financial statements; revises and incorporates the objective of a review engagement in a new section of AR section 100 entitled, “Objective of a Compilation Engagement;” and provides that in a review engagement, the accountant must (1) apply analytical procedures to the financial statements; (2) make inquiries of management or other company personnel, or both; and (3) obtain representations from management for all financial statements and periods covered by the accountant’s review report. SSARS No. 17 also revised AR section 100 to properly state the preceding requirement with respect to analytical procedures.

- revises the definition of third parties to clarify that the phrase “who are knowledgeable about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of financial statements” applies to “members of management.”

- introduces definitions of those charged with governance and management into AR section 100.

- revises AR section 100 to state that because review procedures include obtaining representations from management that they have taken responsibility for all financial statements and periods covered by the accountant’s review report, and because the accountant’s review report should be dated as of the completion of the accountant’s review procedures, as well as the fact that the accountant is concerned with events occurring through the date of the review report that may require adjustment to or disclosure in the financial statements, management’s written representations should be made as of the date of the accountant’s review report.

- provides guidance with respect to an accountant’s consideration of the entity’s ability to continue as a going concern during the performance of compilation or review procedures.

- provides guidance with respect to an accountant’s consideration of subsequent events in a compilation or review engagement.

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1 SSARS No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008* (AICPA, *Professional Standards*, vol. 2), amends some of the guidance for compilation and review engagements and is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008, with early application permitted. Due to the issuance of SSARS No. 17, AR sections 100, 9100, 200, 300, 9300, and 400 have been moved to AR sections 100A, 9100A, 200A, 300A, 9300A, and 400A, respectively, of Professional Standards until the effective date of SSARS No. 17. This alert references the “A” sections, where applicable, when referring to specific paragraphs of the standards as they existed before issuance of SSARS No. 17.
• deletes the word primarily from AR section 100A paragraph .70 (Supplementary Information), which stated that “the review has been made primarily for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles.”

• incorporates guidance with respect to analytical procedures in a review engagement as an exhibit (exhibit A) to the codification of SSARSs. In addition to exhibit A, “Analytical Procedures in a Review Engagement,” the AICPA has separately issued exhibit B, “Going Concern Considerations,” and exhibit C, “Subsequent Events Considerations,” to provide nonauthoritative accounting guidance to assist practitioners performing compilation and review engagements. These exhibits can be found online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee/Nonauthoritative+Exhibits+to+the+SSARSs+Codification.htm.

.19 SSARS No. 17 is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008. Early application is permitted.

Recently Issued Compilation and Review Interpretations of the SSARSs

.20 Compilation and review interpretations of the SSARSs are interpretive publications pursuant to AR section 50, Standards for Accounting and Review Services (AICPA, Professional Standards, vol. 2). Interpretive publications are not standards for accounting and review services. Interpretive publications are recommendations on the application of SSARSs in specific circumstances, including engagements for entities in specialized industries. An interpretive publication is issued after all ARSC members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with the SSARSs.

.21 The accountant should be aware of and consider interpretive publications applicable to his or her compilation or review. If the accountant does not apply the guidance included in an applicable interpretive publication, the accountant should be prepared to explain how he or she complied with the SSARSs provisions addressed by such guidance.

Interpretation No. 24 of AR Section 100

.22 In response to the AICPA’s governing council vote to designate the International Accounting Standards Board (IASB) as an international accounting standard setter for purposes of establishing international financial accounting and reporting principles, the ARSC revised Interpretation No. 24, “Reference to the Country of Origin in a Review or Compilation Report,” of AR section 100 (AICPA, Professional Standards, vol. 2, AR sec. 9100 par. .93–.94). This interpretation states that there is no prohibition to referencing the country of origin in either a compilation or review report. The interpretation also includes an example of an emphasis of a matter paragraph that can be added to a compilation report to reference the country of origin of the accounting principles used to prepare financial statements, as follows:

As disclosed in note X, the accompanying financial statements were prepared in accordance with accounting principles generally accepted in the United States of America.

.23 The interpretation also states that the accountant may modify the third paragraph of the standard review report to read as follows:

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.
Interpretation No. 30 of AR Section 100

.24 Also, in response to the AICPA’s governing council vote to designate the IASB as an international accounting standard setter for purposes of establishing international financial accounting and reporting principles, the ARSC issued Interpretation No. 30, “Considerations Related to Financial Statements Prepared in Accordance With International Financial Reporting Standards and Compilations and Reviews Performed in Accordance With International Standards,” of AR section 100 (AICPA, Professional Standards, vol. 2, AR sec. 9100 par. .130–.135). It is expected that now that the IASB has been designated as an accounting standard setter, accountants will be requested to compile and review financial statements based on International Financial Reporting Standards (IFRS) as established by the IASB. As such, the accountant may determine to modify the standard compilation or review report to reflect that the financial statements were prepared in accordance with IFRS, rather than U.S. generally accepted accounting principles (GAAP).

.25 Therefore, the accountant may determine to modify the standard compilation report by adding the following emphasis of matter paragraph as the third paragraph of the report:

As disclosed in Note X, the accompanying financial statements were prepared in conformity with International Financial Reporting Standards as issued by the International Accounting Standards Board.

.26 When the accountant compiles financial statements that omit substantially all disclosures, but are otherwise in conformity with IFRS as issued by the IASB, the accountant may wish to modify the third paragraph of the standard report as follows:

Management has elected to omit substantially all disclosures (and the statement of cash flows) required by International Financial Reporting Standards as issued by the International Accounting Standards Board. If the omitted disclosures and statement were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

.27 When the accountant reviews financial statements prepared in accordance with IFRS, the accountant would refer, in the accountant’s report, to IFRS rather than U.S. GAAP.

.28 An example of the third paragraph in an accountant’s review report is as follows:

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with International Financial Reporting Standards as issued by the International Accounting Standards Board.

.29 The interpretation also states that the accountant may apply the reporting guidance in AR section 100 paragraphs .56–.58 regarding departures from U.S. GAAP when engaged to report on financial statements presented in accordance with a jurisdictional variation of IFRS.

.30 This interpretation also clarifies that an accountant performing a compilation or review of historical financial statements of a U.S. entity is required to follow the SSARSs but can also perform the compilation or review in accordance with international standards. The interpretation provides examples of what a compilation report and review report might look like in these circumstances.

Current ARSC Projects

Reliability

.31 At its meeting in April/May 2008, the ARSC approved a project to develop a framework for the performance of compilation and review engagements. Such framework would permit the expression of limited assurance on reviewed financial statements for an entity with respect to whom the accountant is not independent due to the performance of certain control activities. As a result, the Reliability Task Force (task
force) was formed with the charge of developing a draft SSARS that would expand the applicability of the compilation and review literature to enable an accountant who maintains his or her objectivity to provide limited assurance on an entity’s financial statements, even though the accountant’s independence may be impaired because he or she performed certain control activities for the entity.

.32 The task force discussed the types of independence impairments that it felt should not preclude an accountant from providing limited assurance under the proposed framework and the limits to the performance of control activities on behalf of the client. The issues were discussed with the ARSC at its meeting in August 2008. The ARSC plans to issue a draft document for public comment in the first half of 2009.

ARSC Clarity Project

.33 The first step in the ARSC’s clarity project was the issuance of SSARS No. 16 in December 2007. The goal of the ARSC’s clarity project is to make the SSARSs easier for users to read, understand, and apply. Over the next few years, the ARSC will examine the existing SSARSs and consider whether any additional revisions are appropriate.

.34 In addition, the ASB has determined that the appropriate format for the SASs is the International Auditing and Assurance Standards Board (IAASB) style. The format used by the IAASB separates the requirements and application material. Application material paragraphs are numbered using an “A” prefix and presented in a separate section that follows the requirements. The ARSC is currently considering whether it deems appropriate to draft the SSARSs so that the standards for compilation and review engagements are consistent in format to the auditing standards.

Requirement to Obtain Engagement Letters

.35 Currently, the SSARSs do not include a requirement for the accountant to obtain an engagement letter for all compilation and review engagements. In considering the revisions to the standard reports that will clarify management’s responsibility (as discussed in the preceding section), the ARSC is considering whether the SSARSs should be revised to require that the accountant obtain an engagement letter on all engagements.

Current Practice Issues

AICPA Guidance for Bookkeeping Engagements

.36 The ARSC is assisting in the development of an AICPA practice aid for bookkeeping engagements. The practice aid, when issued, will focus on how existing standards apply to bookkeeping engagements, specifically Statements on Quality Control Standards (SQCSs), including client acceptance and continuance procedures and communication of best practices. In addition, the practice aid should address certain practical situations, such as whether a compilation report is necessary if financial statements are prepared, as well as issues regarding accountant independence. This practice aid is expected to be issued in 2009.

OCBOA Task Force

.37 Over the past few years, many practitioners have noted that it would be beneficial to have nonauthoritative accounting guidance as it relates to an other comprehensive basis of accounting (OCBOA). In 2007, the ARSC took the lead on creating a cross-functional task force that has been charged with developing an OCBOA practice aid that will provide guidance to preparers.

SQCS No. 7, A Firm’s System of Quality Control

.38 On October 10, 2007, SQCS No. 7, A Firm’s System of Quality Control (AICPA, Professional Standards, vol. 2, QC sec. 10), was issued. This new SQCS supersedes existing statements on quality control standards and differs from them as follows:
• Defines the term *engagement quality control review* and requires firms to establish which engagements are to be subject to an engagement quality control review.

• Defines the terminology the ASB uses to describe the degrees of responsibility that the requirements in SQCSs impose on firms, which includes use of the terms *unconditional requirements* and *presumptively mandatory requirements*.

• Requires a firm to document its quality control policies and procedures. The extent of the documentation is based on the size, structure, and nature of the firm’s practice.

• Requires a firm’s system of quality control to address each of the following elements: leadership responsibilities for quality within the firm, relevant ethical requirements, acceptance and continuance of client relationships, human resources, engagement performance, and monitoring.

• Recognizes the importance of a quality-oriented internal culture and requires firms to (a) establish policies that require the firm to assign its management responsibilities so that commercial considerations do not override the quality of work performed, and (b) address personnel performance evaluation, compensation, and advancement to demonstrate the firm’s overarching commitment to quality.

• Provides more detailed guidance on independence and requires a written confirmation of compliance with independence requirements from all firm personnel at least annually.

• Provides more detailed guidance on client acceptance and continuance and requires documentation of the resolution of significant issues.

• Provides more detailed guidance on engagement supervision and review, engagement documentation, and consultation policies and procedures.

• Requires policies and procedures for resolving differences of opinions, including a requirement that reports must not be released until all differences of opinions are resolved.

• Requires performance of monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and regulatory requirements and the firm’s quality control policies and procedures.

• Requires policies and procedures for dealing appropriately with complaints and allegations of noncompliance with professional standards or with the firm’s system of quality control.

.39 This SQCS is effective as of January 1, 2009.

**Accountants Engaged to Prepare Financial Statements**

.40 The question has come up among practitioners about whether an accountant who is engaged to prepare financial statements that will be audited by another firm would be required to follow guidance in the SSARSs.

.41 Interpretation No. 21, “Applicability of SSARS No. 1 When Performing Controllership of Other Management Services,” of AR section 100 (AICPA, *Professional Standards*, vol. 2, AR sec. 9100 par. 80–84), states that “if the accountant is in the practice of public accounting as defined by the AICPA’s Code of Conduct and is not a stockholder, partner, director, officer, or employee of the entity, the accountant is required to follow the performance and communication requirements of SSARS No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100), including any requirement to disclose a lack of independence.”

**Common Peer Review Findings**

.42 In 2007, the AICPA Peer Review Program reported approximately 10,000 peer reviews, of which approximately 5,400 pertained to compilation and review engagements. The importance of peer review
findings cannot be overemphasized. Some of the significant deficiencies identified related to compilation and review engagements include the following:

- Failure to perform analytical and inquiry procedures and failure to adequately document the procedures
- Failure to document the matters covered in the accountant’s inquiry and analytical procedures
- Failure to obtain a client management representation letter
- Failure to modify the standard review report to indicate a departure from U.S. GAAP with respect to the classification of long-term debt
- Engagement letters on SSARS No. 8, Amendment to Statement on Standards for Accounting and Review Services No. 1, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2, AR sec. 100) engagements that omit the required descriptions or statements documenting the understanding with the client


Accounting Issues and Developments

Convergence With International Financial Reporting Standards

Since the signing of the Norwalk Agreement by the Financial Accounting Standards Board (FASB) and IASB, the bodies have had a common goal—one set of accounting standards for international use. In this agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. During meetings held in 2005, FASB and the IASB reaffirmed their commitment to the convergence of U.S. GAAP and IFRS. A common set of high quality, globally accepted standards remains the long-term strategic priority of both FASB and the IASB.

FASB and the IASB have undertaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and IFRS. These ongoing joint projects address the conceptual framework, business combinations, financial statement presentation, and revenue recognition. For more information on the status of this project, go online to www.fasb.org and www.iasb.org.

AICPA Launches IFRS.com Web Site

The AICPA is calling for an orderly transition and reasonable time frame of three to five years for the U.S. accounting profession to adopt IFRS. During a FASB forum on June 16, 2008, held to facilitate an open dialogue about whether and how to move the U.S. financial reporting system to IFRS and define the next steps in that process, it was noted that awareness of IFRS is growing, but most believe it will take three to five years to prepare.

To assist in both awareness building and education, the AICPA launched a new Web site, www.ifrs.com, in May 2008. The site provides current information about developments in international convergence. The growing acceptance of IFRS as a basis for U.S. financial reporting represents a fundamental change for the U.S. accounting profession. Acceptance of a single set of high quality accounting standards for worldwide use by public companies has been gaining momentum around the globe for the past few years.

Developed by the AICPA, in partnership with its marketing and technology subsidiary, CPA2Biz, IFRS.com provides a comprehensive set of resources for accounting professionals, auditors, financial managers, audit committees, and other users of financial statements.
The Web site features tools and resources to help CPAs get acquainted with IFRS, the surrounding issues, and available support. Resources include a history of convergence, a high level overview of the differences between IFRS and U.S. GAAP, frequently asked questions, articles, textbooks, continuing professional education (CPE) courses and live conference training, helpful links, and assistance for audit committee members.

**FASB Accounting Standards Codification™**

On January 15, 2008, FASB launched the one-year verification period of the FASB Accounting Standards Codification™ (codification). The codification is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing all authoritative literature in a topically organized structure. The codification includes all accounting standards issued by a standard setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, AICPA, Emerging Issues Task Force (EITF), and related literature. The codification also includes relevant authoritative content issued by the Securities and Exchange Commission (SEC), as well as selected SEC staff interpretations and administrative guidance.

The purpose of the codification is not to change GAAP, but rather to reorganize thousands of GAAP pronouncements into approximately 90 topics. At the end of the one-year verification period, FASB is expected to formally approve the codification as the single source of authoritative U.S. accounting and reporting standards, other than guidance issued by the SEC. At that time, FASB will supersede all then-existing, non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the codification will become nonauthoritative. FASB expects to approve the codification in April 2009.

The codification can be accessed online at http://asc.fasb.org/home. Constituents are encouraged to use FASB’s online Codification Research System free of charge and provide feedback to FASB on the codification.

The AICPA has published the Financial Reporting Alert FASB Codification Developments—2008 (product no. 029209kk). This Financial Reporting Alert is intended to provide a better understanding of the codification, outline the structure of the codification, as well as provide case studies on how to navigate the FASB Accounting Standards Codification™ Research System and perform accounting research.

**Summary of Recent Accounting Pronouncements and Related Guidance**

Presented in the following table is a list of recently issued accounting pronouncements and related guidance. This alert is intended to be used in conjunction with the AICPA Comprehensive Audit Risk Alert—2008 (product no. 022339kk); therefore, only certain pronouncements and related guidance or those of specific significance to compilation and review engagements are summarized herein. For information on accounting standards issued subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the CPA Letter and Journal of Accountancy.

<table>
<thead>
<tr>
<th>Recent Accounting Pronouncements and Related Guidance</th>
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<tbody>
<tr>
<td>FASB Statement No. 162 (May 2008)</td>
<td>The Hierarchy of Generally Accepted Accounting Principles</td>
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<tr>
<td>Source</td>
<td>Description</td>
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<td>------------------------------------------</td>
<td>-----------------------------------------------------------------------------</td>
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<tr>
<td>FASB Statement No. 161 (March 2008)</td>
<td>Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133</td>
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<tr>
<td>FASB Statement No. 160 (December 2007)</td>
<td>Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51</td>
</tr>
<tr>
<td>FASB Statement No. 141 (revised 2007)</td>
<td>Business Combinations</td>
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<tr>
<td>FASB Statement No. 158 (September 2006)</td>
<td>Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)</td>
</tr>
<tr>
<td>FASB Statement No. 157 (September 2006)</td>
<td>Fair Value Measurements</td>
</tr>
<tr>
<td>FASB Interpretation (FIN) No. 48 (June 2006)</td>
<td>Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109</td>
</tr>
<tr>
<td>FASB Staff Positions (Various dates)</td>
<td>Go to <a href="http://www.fasb.org/fasb_staff_positions/">www.fasb.org/fasb_staff_positions/</a> for a complete list of FSPs.</td>
</tr>
<tr>
<td>AICPA Statement of Position (SOP) 07-1 (AICPA, Technical Practice Aids, ACC sec. 10,930)</td>
<td>Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies</td>
</tr>
</tbody>
</table>

In February 2008, FASB issued FSP SOP 07-1-1, Effective Date of AICPA Statement of Position 07-1, which indefinitely defers the effective date of SOP 07-1. Entities that early adopted SOP 07-1 before December 15, 2007 are permitted but not required to continue to apply the provisions of the SOP. No other entities may adopt the provision of the SOP, subject to the exception in the following sentence. If a parent entity that early adopted the SOP chooses not to rescind its early adoption, an entity consolidated by the parent entity that is formed or acquired after that parent entity’s adoption of the SOP must apply the provisions of the SOP in its stand-alone financial statements.
<table>
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<tr>
<th><strong>AICPA Technical Practice Aid (TPA)</strong></th>
<th><strong>Technical Questions and Answers (TIS)</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Technical Questions and Answers (TIS)</td>
<td>sections 6910.25–.28 (AICPA, Technical Practice Aids)</td>
</tr>
<tr>
<td>(Nonauthoritative)</td>
<td>These questions and answers discuss financial statement presentation considerations for investment companies.</td>
</tr>
</tbody>
</table>

| **TIS section 6140.20–.22 (AICPA, Technical Practice Aids)** | These questions and answers discuss not-for-profit organizations fund-raising expenses. |
| **TIS section 6931.08–.10 (AICPA, Technical Practice Aids)** | These questions and answers discuss various employee benefit plan topics. |
| **AICPA Practice Guide** | **Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48** |
| (Nonauthoritative) | (Nonauthoritative) |

.55 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance to compilation and review engagements are briefly explained here. The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. The AICPA Comprehensive Audit Risk Alert—2008 and other AICPA industry-specific alerts also contain summaries of recent pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or visit www.cpa2biz.com.

**Deferral of FASB Interpretation No. 48 for Certain Nonpublic Entities**

.56 FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109, was issued in June 2006 and is effective for fiscal years beginning after December 15, 2006. However, subsequent to its issuance, FASB issued FASB Staff Position (FSP) FIN 48-2, Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises, which defers the effective date of FIN 48 for nonpublic enterprises included in the FSP’s scope to the annual financial statements for fiscal years beginning after December 15, 2007. For the full text of FIN 48 and its associated FSPs, visit the FASB Web site.

**Recent AICPA Independence and Ethics Pronouncements**

.57 AICPA Independence and Ethics Alert—2007/08 (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

**On the Horizon**

.58 Accountants should keep abreast of compilation, review, and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to your clients or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.59 The following table lists the various standard-setting bodies’ Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting, compilation, and review projects exist in addition to those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.
**Help Desk**—The AICPA’s standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to service@aicpa.org. Indicate “exposure draft e-mail list” in the subject header field to help process your submission more efficiently. Include your full name, mailing address, and, if known, your membership and subscriber number in the message. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

## SSARSs Pipeline

.60 The ARSC is currently working on the following new projects.

### Recodification

.61 The ARSC has been considering a reorganization of the codification of SSARSs. The ARSC has envisioned a codification that contains separate “chapters” for compilation and review engagements, as follows:

1. SSARSs hierarchy
2. Compilation of financial statements
   - Establishing an understanding with the entity
   - Performance of a compilation engagement
   - Reporting on compiled financial statements
3. Review of financial statements
   - Establishing an understanding with the entity
   - Performance of a review engagement
   - Reporting on reviewed financial statements
4. Compilation on specified elements, accounts, or items of a financial statement
   - Establishing an understanding with the entity
b. Performance of a compilation of specified elements, accounts, or items of a financial statement

c. Reporting on compiled specified elements, accounts, or items of a financial statement

5. Compilation of pro forma information

a. Establishing an understanding with the entity

b. Performance of a compilation of pro forma financial information

c. Reporting on compiled pro forma information

6. Exhibits

.62 At their meeting in May 2008, the ARSC considered the effect of its current and expected projects on a recodification. The ARSC tentatively plans to expose proposed chapters during the fourth quarter of 2009 and during 2010.

International Review and Compilation Standards

.63 The IAASB is currently looking at whether its standards for review and compilation engagements remain appropriate. It is not anticipated they will complete their project before 2010. However, the ARSC is currently looking at existing international standards for review and compilation engagements prior to the issuance of “recodified” SSARSs. The ARSC believes that a harmonization with international standards will assist practitioners, especially those practitioners that are engaged to review the financial statements prepared in conformity with IFRS, as issued by the IASB.

Accounting Pipeline

.64 A number of accounting projects and pronouncements are currently in progress. For a summary of significant accounting projects and pronouncements, refer to AICPA Comprehensive Audit Risk Alert—2008 (product no. 022339kk). Such in-progress issues include the following:

- Accounting for hedging activities exposure draft
- Accounting for contingencies exposure draft
- Phase 2 of the fair value project
- Transfers of financial assets project
- Income tax convergence project

Proposed FASB Emerging Issues Task Force Issues and Staff Positions

.65 Proposed FASB EITF Issues. Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

.66 Proposed FSPs. A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

Resource Central

.67 The following are various resources that practitioners performing compilation and review engagements may find beneficial.
Publications

Practitioners may find the following publications useful with respect to compilation and review engagements. Choose the format that is best for you—online, print, or CD-ROM.

- **Review Engagements: New and Expanded Guidance on Analytical Procedures Inquiries and Other Procedures** (product no. 006618kk [paperback])
- **Defining Professional Requirements in Statements on Standards for Accounting and Review Services—SSARS No. 16** (product no. 060654kk [paperback])
- **Omnibus Statement on Standards for Accounting and Review Services 2008—SSARS No. 17** (product no. 060655kk [paperback])
- **Audit and Accounting Manual** (2008) (product no. 005138kk [paperback], WAM-XX [online], or AAM-XX [loose leaf])
- **Accounting Trends & Techniques, 62nd Edition** (product no. 009900kk [paperback] or WAT-XX [online])

Additional resources for accountants in business and industry are the Financial Reporting Alert series, designed to be used by members of an entity’s financial management to identify and understand current accounting and regulatory developments affecting the entity’s financial reporting.

- **Financial Reporting Alert Current Accounting Issues and Risks—2008** (product no. 029208kk)
- **Financial Reporting Alert FASB Codification Developments—2008** (product no. 029209kk)

AICPA reSOURCE: Accounting and Attest Literature

The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm’s needs. Or, if you prefer to have access to the entire library, that is available too. Get access—anytime, anywhere—to the AICPA’s latest Professional Standards, Technical Practice Aids, Audit and Accounting Guides (more than 20), Audit Risk Alerts (more than 15), and Accounting Trends & Techniques. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Continuing Professional Education

The AICPA offers a number of CPE courses that are valuable to CPAs performing compilation and review engagements, including the following:

- **AICPA’s Annual Accounting and Auditing Update Workshop (2008–2009 Edition)** (product no. 736184kk [text] or 187192kk [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- **International Versus U.S. Accounting: What in the World is the Difference?** (product no. 731666 [text]). With the fast pace of the convergence project, understanding the differences between IFRS and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRS and U.S. GAAP.
- **The International Financial Reporting Standards: An Overview** (product no. 157220 [online] or 739750HS [DVD]). This course captures a live presentation on IFRS given to the AICPA Board of Directors.

Among the many courses, the following are specifically related to compilation and review engagements:

- **Compilation and Review Engagement Essentials** (product no. 733678kk [text])
- **Managing Compilation, Review and Accounting Services** (product no. 733480kk [text])

Visit www.cpa2biz.com for a complete list of CPE courses.
Online CPE

AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA’s flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 for a new subscription and $119 for the annual renewal. Nonmembers pay $369 for each. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to those performing compilation and review engagements include the following:

- 2008 Annual Update—Accounting & Auditing: Compilation and Review Update
- Compilation & Review Engagements: Environmental, Accounting, and Reporting Issues; Potential Change
- Compilations and Reviews: Introduction and Background
- Drafting Audit, Review, and Compilation Reports
- Intro to Cash and Tax OCBOAs and Their Effects on Procedures in Audits, Reviews, and Compilations
- Types and Scope of Compilation Engagements
- Compilation & Review Engagements: Recent SSARS Developments and Current Practice Issues
- Compilations and Reviews: Engagement Planning, Administration, and Quality Control
- Compilations & Reviews: Independence Considerations

To register or learn more, visit www.cpa2biz.com.

Webcasts

Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession’s leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of “hot topics” that successful organizations employ and subjects that are important to the CFO’s personal success. From financial reporting and budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

Member Service Center

To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA’s Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. Beginning January 14, 2008, hotline hours were extended so that the hotline is now available from 9am to 8pm on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/.
Ethics Hotline

.80 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA’s Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077.

* * * *


.82 This Compilation and Review Alert is published annually. As you encounter issues that you believe warrant discussion in next year’s Compilation and Review Alert, please feel free to share them with us. Any other comments that you have about this alert would also be appreciated. You may e-mail these comments to killuzzi@aicpa.org or write to

Kristy L. Illuzzi, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110
## Appendix A—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

<table>
<thead>
<tr>
<th>Web Site Name</th>
<th>Content</th>
<th>Web Site</th>
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</thead>
<tbody>
<tr>
<td>American Institute of CPAs (AICPA)</td>
<td>Summaries of recent auditing and other professional standards as well as other AICPA activities</td>
<td><a href="http://www.aicpa.org">www.aicpa.org</a>&lt;br&gt;www.cpa2biz.com&lt;br&gt;www.ifrs.com</td>
</tr>
<tr>
<td>AICPA Accounting Standards Executive Committee (AcSEC)</td>
<td>Issues guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards</a></td>
</tr>
<tr>
<td>AICPA Accounting and Review Services Committee (ARSC)</td>
<td>Develops and issues review and compilation standards and interpretations</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee</a></td>
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<tr>
<td>AICPA Professional Issues Task Force (PITF)</td>
<td>Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force</a></td>
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<tr>
<td>Economy.com</td>
<td>Source for analyses, data, forecasts, and information on the United States and world economies</td>
<td><a href="http://www.economy.com">www.economy.com</a></td>
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<tr>
<td>The Federal Reserve Board</td>
<td>Key interest rates</td>
<td><a href="http://www.federalreserve.gov">www.federalreserve.gov</a></td>
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<td>Portal through which all government agencies can be accessed</td>
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<tr>
<td>International Federation of Accountants (IFAC)</td>
<td>Information on standards-setting activities in the international arena</td>
<td><a href="http://www.ifac.org">www.ifac.org</a></td>
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<tr>
<td>Private Company Financial Reporting Committee (PCFRC)</td>
<td>Information on the initiative to further improve FASB’s standard-setting process to consider needs of private companies and their constituents of financial reporting.</td>
<td><a href="http://www.pcfr.org">www.pcfr.org</a></td>
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</tbody>
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[The next page is 8105.]
AAM Section 8030

Health Care Industry Developments—2008

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of health care organizations with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an other auditing publication as defined in AU section 150, Generally Accepted Auditing Standards (AICPA, Professional Standards, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in another auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Zachary T. Donahue, CPA
Senior Technical Manager
Accounting and Auditing Publications

Acknowledgments

The AICPA staff is grateful to the members of the AICPA Health Care Expert Panel and the chair of that panel, Rick Corcoran, for their assistance and contributions to this Audit Risk Alert.

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your health care industry audits. This alert can also be used by an entity’s internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool in helping you identify the significant risks that may result in the material misstatement of financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This alert is intended to be used in conjunction with AICPA Comprehensive Audit Risk Alert—2008 (product no. 022339kk). This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.03 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error
or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor’s understanding of the entity and its environment includes the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity’s financial performance
- Internal control, which includes the selection and application of accounting policies

.04 The health care industry may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.05 The auditor should obtain an understanding of the entity’s objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity’s ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies.

.06 Just as the external environment changes, the conduct of the entity’s business is also dynamic, and the entity’s strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.07 After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

.08 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client’s environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

**Economic and Industry Developments**

**The State of the Economy**

.09 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on the entity’s financial statements being audited.

.10 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.2 percent in 2007. According to 2008 second quarter final estimates, real GDP increased at an annual rate of 2.8 percent, which is up significantly from the 0.9 percent rate in the first quarter of 2008.

.11 The unemployment rate remained relatively unchanged during 2007, holding between 4.4 percent and 5.0 percent, with an annual average rate of 4.6 percent. However, during 2008, the unemployment rate
has risen. As of September 2008, the unemployment rate was 6.1 percent, representing approximately 9.5 million people.

.12 The target for the federal funds rate remained stable at 5.25 percent from June 2006 to September 2007 when the Federal Reserve began decreasing rates. Since the first rate decrease in September 2007, the Federal Reserve has decreased rates a total of 3.75 percentage points to 1.50 percent as of mid-October 2008. The Federal Reserve noted in its October press release that strains in financial markets have increased significantly, and labor markets have weakened further. Incoming economic data suggest that the pace of economic activity has slowed markedly in recent months. Moreover, the intensification of financial market turmoil is likely to exert additional restraint on spending, partly by further reducing the ability of households and businesses to obtain credit. Inflation has been high, but the Federal Open Market Committee, which sets the nation’s monetary policy, believes that the decline in energy and other commodity prices and the weaker prospects for economic activity have reduced the upside risks to inflation.

**Industry Trends and Conditions**

**Impact of the Current Credit Crisis**

.13 The significant disruptions in the global credit markets in 2007 and 2008 are having broad, sweeping effects on a wide variety of industry sectors, including health care. These disruptions are creating a significant number of accounting and financial reporting concerns and have led to

- declines in the fair values of many investment securities as a result of credit issues primarily involving U.S. mortgage products;
- liquidity and funding concerns, including a significant contraction in commercial paper and other short-term funding sources;
- debt covenant compliance concerns;
- an inability of hedge funds to reliably value certain of their holdings, halting redemption requests and filing for bankruptcy protection; and
- a concern that the net asset value of some money-market funds may decline to less than one dollar per share.

.14 Although the problems began in the U.S. housing market, they have extended beyond sub-prime mortgage products and spread rapidly throughout the global financial marketplace, triggering negative economic consequences. The volatility in the debt and equity markets can adversely affect companies in all industry sectors, particularly with valuation of investment portfolios and tighter lending standards curbing the flow of capital.

.15 For example, many health care organizations have significant investment portfolios, including alternative investments that may be adversely affected by current market conditions. Management is responsible for the valuation of all investments in the financial statements, and this responsibility cannot be outsourced or assigned to a third party.

.16 Due to the current market instability, accounting is increasingly complex:

- Determining the fair values of financial instruments (for example, investment securities, alternative investments and derivatives) has become more challenging due to changes in market liquidity.
- Many potential accounting considerations involve significant accounting estimates, for example, valuation of investments not traded in active markets.
- Current conditions may require a greater use of judgment.
- Organizations and their external auditors may need to rely on specialists more extensively.
The valuation of money-market funds, commercial paper, asset-backed securities, and alternative investments all need to be considered, as well as the accounting treatment for other-than-temporary declines in the fair value of investments. Significant debt agreements and covenants could be affected by adverse change clauses and material subjective acceleration clauses. Consideration should be given to debt expected to be refinanced in the near term as well as short-term debt facilities.

Also, many organizations are in the process of changing the mode of interest on their long-term debt. In the wake of the current market turmoil, organizations must understand their risks and evaluate the impact of planned transactions in order to address those risks on the financial statements.

In May 2008, the AICPA released a nonauthoritative article, “Tax-Exempt Bonds—Accounting and Auditing Considerations in the Current Environment.” The article focuses on issuers of auction rate securities and variable rate demand obligations, and provides issuers of tax-exempt debt with an overview of the accounting considerations that may be relevant in light of recent market events. The article may be accessed at www.aicpa.org/download/acctstd/ARS_article14.pdf.

Managed Investment Portfolios

Health care organizations often outsource the management of their investment portfolios to third-party investment managers. In some cases, the health care organization places restrictions on the trading activities of the third-party investment manager such that management maintains control over investment decisions, for instance, determining when to buy or sell specific securities. In most cases, however, no such restrictions are placed on the third-party investment manager.

When restrictions have not been imposed, management of the health care organization typically may not assert that it has the intent and ability to hold any impaired investments (for which cost is less than fair value) until recovery. Without the intent and ability to hold an impaired security until anticipated recovery, the health care organization is precluded from considering the impairment to be temporary. Other-than-temporary impairment losses are included within net income, or, for not-for-profit health care organizations, the performance indicator (typically referred to as the excess of revenues and gains over expenses), and a new cost basis for that security is established.

Health care organizations that outsource their investment management function should review their investment management agreements and determine the appropriate accounting treatment for any impaired securities.

Legislative and Regulatory Developments

U.S. Department of Health and Human Services

Office of Inspector General


Time and Effort Reporting

Time and effort reporting continues to be a challenging area, particularly for organizations that receive funding from the HHS. In most federal awards, personnel costs, including direct labor charges,
Municipal Securities Rulemaking Board

**New Electronic Municipal Market Access System for Municipal Disclosure Documents**

.25 The Municipal Securities Rulemaking Board is working to implement Electronic Municipal Market Access (EMMA), a municipal market version of the Securities and Exchange Commission’s (SEC’s) Electronic Data Gathering, Analysis, and Retrieval system that makes annual, quarterly, and material events information of SEC registrant companies publicly available. EMMA is expected to be implemented in stages, with the initial stage for official statements and advance refunding documents.

.26 Additional stages will expand to allow EMMA to become a complete online public dissemination vehicle. At that point, all official statements, annual and quarterly financial information, and material event notices for all issuers required to make continuing disclosure filings under SEC Rule 15c2-12 would be made available online free of charge. The system would also provide trade pricing information for municipal securities that is similar to the New York Stock Exchange or NASDAQ.

.27 Initial submissions to EMMA are voluntary; however, the SEC is expected to eventually mandate its use to replace the current vendor-based system of nationally recognized municipal information repositories, as well as Disclosure USA, the disclosure facility operated by the Municipal Advisory Council of Texas.

Centers for Medicare and Medicaid Services

.28 The Center for Medicare and Medicaid Services (CMS) has experienced much activity during the past year; however, the following matters seem to affect health care organizations and their auditors the most.

**CMS Risk Share/Medicare Part D**

.29 Many health care organizations participate in the Medicare Part D drug benefit program. Through the program, millions of older Americans who are Medicare eligible obtain access to prescription drugs independent of their other health care coverage. Under the drug benefit program, CMS has agreed to share in the ultimate experience of a health care organization’s pharmacy benefit costs if certain variances from estimated experience result (the CMS Risk Share). The CMS Risk Share is based on whether the ultimate per-member, per-month pharmacy benefit costs of any Medicare Part D regional plan vary more than 2.5 percentage points above or below the level estimated in the managed care organization’s original bid submitted to and approved by CMS.

.30 Based on the ultimate experience, CMS determines a risk share receivable or payable for the health care organization and subsequently settles the amounts with the health care organization.

.31 When planning and performing audit engagements, an auditor should (1) understand how the entity calculates its risk share portion of its Medicare Part D plan, (2) understand the underlying accounting for such risk-sharing balance being recorded by the entity (including the settlement process), and (3) understand the entity’s corresponding internal control environment. The auditor should determine the extent of testing to be performed on the assumptions and data used by management to estimate this balance.

**Accounting for Risk-Adjusted Revenues for Certain Medicare Products**

.32 Health care organizations have arrangements with CMS for certain Medicare products whereby periodic changes in member “risk factor adjustments scores” (for certain diagnoses codes) result in changes to Medicare revenues. These health care organizations are required to submit encounter data to CMS via the Risk Adjustment Payment System on a regular basis. CMS then applies the health care organization’s
encounter data to the hierarchical condition category payment methodology to impute payments that accompany the monthly payment report. Health care organizations calculate “baseline” risk scores and compare these scores to the “final” risk-adjusted scores to establish the “incremental” difference that is used, in combination with eligibility information, to establish additional revenue by member.

.33 Because the Medicare risk adjustment may represent a significant estimate recorded in the entity’s financial statements, when planning and performing audit engagements, an auditor should (1) assess the health care organization’s methodology used to determine the risk score adjustments, (2) understand the related internal control environment, (3) test the underlying assumptions (using a Medicare compliance specialist when material), and (4) assess the risk-adjusted revenues for reasonableness. Auditors then determine whether the revenue recorded meets the appropriate revenue recognition criteria and whether related receivables are collectible.

.34 Because of the complexities associated with estimating such premium adjustments, auditors should consider whether consulting a specialist is necessary in order to properly design and complete the necessary audit procedures. Further, auditors should assess the adequacy and appropriateness of the health care organization’s financial statement disclosures, including those related to significant changes in estimates.

Internal Revenue Service

Form 990 Redesigned for Tax Year 2008

.35 In December 2007, the IRS issued an updated version of Form 990 for tax year 2008 (which will be filed in 2009) to enhance transparency, promote tax compliance, and minimize the burden on the filing organization. Form 990 now consists of an 11-page core form, which is to be completed by all filers, and 16 schedules designed by topic (lobbying, related parties, compensation, and so on). A transition period allows smaller organizations and certain schedules pertaining to hospitals and tax-exempt bonds to use Form 990-EZ.

.36 Substantial changes have been made to the amount and type of information required on the new Form 990. Some of the more significant changes include the following:

- More questions regarding organizational governance practices
- Disclosure of information from the organization’s audited financial statements
- Expansion of compensation information disclosures
- Expansion of disclosures regarding programs and activities of the organization

.37 The IRS issued preliminary instructions and a glossary for use with Form 990 in April 2008. More information, including drafts of the form and schedules, is available at www.irs.gov/charities/article/0,,id=176613,00.html.

Exempt Organization Abusive Tax Avoidance Transactions

.38 Tax-exempt organizations, by definition, are exempt from federal income tax under various provisions of the Internal Revenue Code (IRC). However, some are directly involved in Abusive Tax Avoidance Transactions (ATATs). In addition, because they are tax-indifferent, tax-exempt organizations are, at times, used by for-profit entities as accommodation parties in these transactions. Identifying and responding to ATATs involving tax-exempt organizations is critical to the IRS objective of discouraging and deterring noncompliance within tax-exempt and government entities.

.39 As a result of provisions included in the Tax Increase Prevention and Reconciliation Act of 2005, the Treasury Department and IRS have issued proposed and temporary regulations under IRC Section 4965, which imposes excise taxes and disclosure requirements with respect to prohibited tax shelter transactions to which tax-exempt entities are parties. The new regulations provide (1) rules regarding the form, manner,
and timing of disclosure obligations and (2) return requirements accompanying payment of excise taxes. The deadline for submitting comments on the proposed regulations has passed. IRS guidance addresses the following issues under this legislation:

- Which entities and individuals are subject to excise tax under the new provisions and which taxes and penalties may apply
- Who is subject to the new provisions
- The treatment of proceeds of transactions received before the effective date of the new provisions
- Disclosure and filing requirements

Additional information is available at www.irs.gov/charities/article/0,,id=172158,00.html.

Certain Charitable Contributions Designated as Transactions of Interest Under New Reportable Transaction Regulations

In September 2007, the IRS issued IRS Notice 2007-72, Transaction of Interest—Contribution of Successor Member Interest, designating certain transactions as having the potential for tax avoidance or evasion and alerting participants to required disclosures and potential penalties. In the transactions, a taxpayer transfers a membership interest in a limited liability company that directly or indirectly owns real property to an IRC Section 501(c)(3) charitable organization or government entity, claiming a charitable contribution deduction for an amount significantly higher than the original purchase price paid by the taxpayer to acquire the interest.

Charitable organizations that receive property in these transactions after August 14, 2007, are participants in these transactions for the first year in which their tax returns reflect the acquired interest, which is generally the year of receipt of the interest. For that year, the charity must disclose certain information to the IRS required by the reportable transaction regulations or be subject to penalties described in the notice. The IRS has begun notifying participating organizations that they have been selected for examination.

Audit and Attestation Issues and Developments

New Filing and Audit Requirements for ERISA-Covered 403(b) Employee Benefit Plans

Beginning in 2009, employee benefit plans sponsored by charitable organizations and schools under IRC Section 403(b) and covered under the Employee Retirement Income Security Act (ERISA) will be subject to the same reporting and audit requirements that currently exist for Section 401(k) plans. Section 403(b) plans are also commonly known as tax-shelter annuity plans.

Under new U.S. Department of Labor (DOL) regulations issued in November 2007 amending the filing requirements for Form 5500, Annual Return/Report of Employee Benefit Plan, ERISA-covered 403(b) plans with 100 or more participants generally will be required to file audited financial statements beginning with their 2009 Form 5500 filing. 403(b) plans with fewer than 100 participants will be eligible to use abbreviated reporting forms without audited financial statements.

The DOL estimates that approximately 7,000 403(b) plans will be subject to the new audit requirements and another 9,000 403(b) plans will be eligible for the waiver. The DOL regulations were published in the November 16, 2007, Federal Register and are available at www.dol.gov/ebsa/regs/fedreg/final/20071116.pdf. The AICPA's Employee Benefit Plan Audit Quality Center and Expert Panel have formed a joint task force to develop resources to help members with these new audit requirements. For more information visit http://ebpaqc.aicpa.org.
Medicare Recovery Audit Contractors


.47 The RACs detect improper Medicare payments, correct the improper payments, and implement actions that will prevent future improper payments. The improper payments are to include both overpayments and underpayments to providers. According to CMS, the RAC demonstration project has identified $357.2 million in overpayments and $14.3 million in underpayments. The RACs are paid a contingency fee based on the amount of improper payments identified. This payment methodology has led to criticism that such an incentive could tempt RACs to identify errors where none exist.

.48 Four years of claims, from October 1, 2001, through September 30, 2005, were available for review under the RAC demonstration project. Under the permanent RAC program, the contractors will review claims paid on or after October 1, 2007, and at no time will they look back more than three years.

.49 The RACs have performed two types of reviews: automated reviews and complex medical reviews. The automated reviews were designed to identify the “low hanging fruit” and used data mining techniques to identify multiple units billed, missing modifiers and payments for discontinued HCPC/CPT codes. The complex medical reviews involved reviewing the medical record or other documentation. They have led to a denial of payments mainly due to lack of medical necessity and missing records or documentation. The RACs were criticized in this area for failing to have knowledgeable and adequately trained staff performing the reviews and the lack of a medical director to interpret the medical records. RACs are now required to have a medical director.

.50 The RAC claim review process for medical records reviews includes the request by the RAC for the medical record or other documentation. Providers have 45 days to comply with the request. If the requested documentation is not submitted within the 45 days, the RAC may identify the claim as an overpayment by default. The RAC has 60 days to review the chart and issue a denial or an “all clear” letter to the provider.

.51 To dispute an RAC adjustment, providers can submit a rebuttal to the RAC or file an appeal following normal Medicare appeal rules. The provider must submit a rebuttal to the RAC within 15 days of the denial. The appeals process has various levels and strict deadlines that cannot be missed.

.52 An appeal must be filed soon after the RAC’s notice of its decision (initial determination). The initial determination date is presumed to be five days after the date of the denial notice or the date of the take-back. The first level of appeal is to file an appeal or redetermination with the Medicare fiscal intermediary (FI) within 120 days after the initial determination. The second level of appeal is with a qualified independent contractor (QIC).

.53 After receiving the decision of the FI, the provider has 180 days to file an appeal with the QIC. The third level of appeal is with an administrative law judge (ALJ). This appeal must be filed within 60 days of the QIC decision. After the ALJ appeal, the next level of appeal is with the Medicare Appeals Council (MAC). This appeal must be filed within 60 days of the ALJ’s decision. If the provider is still dissatisfied with the determination, the provider can file legal proceedings in U.S. District Court within 60 days of the MAC determination.

.54 Providers can prepare for the RAC program by developing a strategy and creating policies and procedures for addressing all RAC notifications. The strategy should address interdepartmental communication to notify clinical, reimbursement, and financial staff of any and all RAC requests. Providers should keep detailed records of all RAC requests, correspondence with the RAC, and the results of the determination.
In the event of any denials, the provider should consider the value of filing a rebuttal or appeal by evaluating the financial impact, the cost versus the benefit of the appeal, and other factors such as availability and accuracy of the medical records and implications of not filing an appeal. Not filing an appeal could force the provider to institute changes in policies and procedures to address the issues raised in the RAC denials and could potentially expose the provider to higher scrutiny and increased medical audits.

Medicare Risk Adjusters

Medicare Advantage Plans (plans) generally receive, from CMS, premium adjustments related to medical encounters that result in calculated risk score adjustments. These premium adjustments can be material to the financial statements of a plan. In addition to obtaining an understanding of a plan’s process to estimate such premium adjustments, auditors should give appropriate consideration to whether the revenue recorded met the appropriate revenue recognition criteria, and whether related receivables are collectible.

Because of the complexities associated with estimating such premium adjustments, auditors may consult a specialist to assist in the design and possibly performance of related audit procedures. Further, auditors should assess the adequacy and appropriateness of a plan’s related financial statement disclosures.

Audit Risks Arising From Current Economic Conditions

Rising food and oil prices, a weak housing market, and a weak U.S. dollar have ripple effects throughout the U.S. economy. Whether the audit client applies for a line of credit, or simply buys office supplies, costs are increasing. The health care industry has seen a general rise in the cost of health care. Effects may also be noted on negotiated managed care contracts. The client may struggle with how to compensate for rising costs and how much its business will be affected by passing those costs onto the customer. Your client’s profit margins are likely to be affected as well. You may find that your clients have renegotiated supplier contracts to seek better payment terms. The client’s customers may be scaling back purchases in an effort to control costs or may not be able to pay promptly, which may cause accounts receivable collection rates to decrease. Recent economic conditions may cause additional risk factors that had not existed or did not have a material effect on audit clients in prior years. When obtaining an understanding of the external factors that affect the entity and the risks associated with those factors, the auditor may consider whether conditions exist that indicate risks of material misstatement. Some examples that relate to economic conditions are as follows:

- Operations that are exposed to volatile markets, which may include oil, agriculture, or currency markets
- Changes in the entity’s supply chain, including surcharges on transportation
- Constraints on the availability of capital and credit
- Going concern and liquidity issues
- Growth in health care costs
- Increase in bad debts related to patient co-pays
- Changes in mix of services

While many of these risks are not new to business, consideration of the many ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks.

Summary of Recent Auditing and Attestation Pronouncements and Related Guidance

Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. This alert is intended to be used in conjunction with AICPA Comprehensive Audit Risk Alert—2008.
(product no. 022339kk); therefore, only industry specific pronouncements and related guidance or those of specific significance to the industry are summarized herein. For information on auditing and attestation standards issued subsequent to the writing of this alert, please refer to the AICPA Accounting and Auditing Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the CPA Letter, Journal of Accountancy, and in the quarterly electronic newsletter In Our Opinion, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

.61 The Public Company Accounting Oversight Board (PCAOB) establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review AICPA Audit Risk Alert SEC and PCAOB Developments—2008 (product no. 022499kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by visiting www.cpa2biz.com.

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<thead>
<tr>
<th>Recent Auditing and Attestation Pronouncements and Related Guidance</th>
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<tr>
<td><strong>Statement on Auditing Standards (SAS)</strong></td>
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<tr>
<td>No. 115, <em>Communicating Internal Control Related Matters Identified in an Audit</em> (AICPA, Professional Standards, vol. 1, AU sec. 325)</td>
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<tr>
<td>Issue Date: October 2008</td>
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<tr>
<td>(Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])</td>
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<tr>
<td>Replacing SAS No. 112, <em>Communicating Internal Control Related Matters Identified in an Audit</em>, this standard defines the terms <em>deficiency in internal control, significant deficiency, and material weakness</em>; provides guidance on evaluating the severity of deficiencies in internal control identified in an audit of financial statements; and requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit. It is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.</td>
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<td><strong>SAS No. 114, The Auditor’s Communication With Those Charged With Governance</strong> (AICPA, Professional Standards, vol. 1, AU sec. 380)</td>
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<td>Issue Date: December 2006</td>
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<td>(Applicable to audits conducted in accordance with GAAS)</td>
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<tr>
<td>Replacing SAS No. 61, <em>Communication With Audit Committees</em>, this standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, to whom they should be communicated, and the form and timing of the communication. It is effective for audits of financial statements for periods beginning on or after December 15, 2006.</td>
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<tr>
<td>Standard</td>
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(Applicable to audits conducted in accordance with GAAS)  
This standard does the following:  
- Revises the terminology used in the 10 standards of AU section 150, *Generally Accepted Auditing Standards*, to reflect terminology in AU section 120, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, Professional Standards, vol. 1).  
- Adds a footnote to the headings before paragraphs .35 and .46 in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, Professional Standards, vol. 1), to provide a clear link between the auditor’s consideration of fraud and the auditor’s assessment of risk and the auditor’s procedures in response to those assessed risks.  
- Replaces throughout the SASs the term *completion of fieldwork* with the term *date of the auditor’s report*.  
- Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor’s report. |
| SAS Nos. 104–111, the risk assessment standards | Issue Date: March 2006  
(Applicable to audits conducted in accordance with GAAS)  
The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits; focusing on identifying and assessing the risks of material misstatements; further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels; and improving the linkage between the risks, controls, audit procedures, and conclusions. These eight SASs became effective for audits of financial statements for periods beginning on or after December 15, 2006. |
This statement establishes requirements and provides guidance that applies when a practitioner is engaged to perform an examination of the design and operating effectiveness of an entity’s internal control over financial reporting (examination of internal control) that is integrated with an audit of financial statements (integrated audit). This SSAE is effective for integrated audits for periods ending on or after December 15, 2008. Earlier implementation is permitted. |
<p>| SSAE No. 14, SSAE Hierarchy (AICPA, Professional Standards, vol. 1, AT sec. 50) | This standard identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in AT section 20, Defining Professional Requirements in Statements on Standards for Attestation Engagements (AICPA, Professional Standards, vol. 1). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006. |
| Issue Date: November 2006 | |
| Auditing Interpretation No. 14, “Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing,” of AU section 508, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1, AU sec. 9508 par. .56–.59) | This auditing interpretation interprets AU section 508 and addresses the application of AU section 508 in reporting on financial statements prepared in conformity with International Financial Reporting Standards (IFRS). |
| Issue Date: March 2002 Revised Date: May 2008 (Interpretive publication) | |
| Auditing Interpretation No. 19, “Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board,” of AU section 508 (AICPA, Professional Standards, vol. 1, AU sec. 9508 par. .93–.97) | This auditing interpretation interprets AU section 508 and addresses the application of AU section 508 in reporting on financial statements prepared in conformity with IFRS. |
| Issue Date: May 2008 (Interpretive publication) | |
| Auditing Interpretation No. 2, “Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board,” of AU section 534, Reporting on Financial Statements Prepared for Use in Other Countries (AICPA, Professional Standards, vol. 1, AU sec. 9534 par. .05–.08) | This auditing interpretation interprets AU section 534 and addresses the application of AU section 534 in reporting on financial statements prepared in conformity with IFRS. |</p>
<table>
<thead>
<tr>
<th>Issue Date: May 2008 (Interpretive publication)</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Issue Date: May 2008 (Interpretive publication)</td>
<td></td>
</tr>
<tr>
<td>Statement of Position (SOP) 07-2, Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisers, or Other Service Providers (AICPA, Technical Practice Aids, AUD sec. 14,430)</td>
<td>This statement addresses the application of SSAEs primarily to examination engagements in which a practitioner reports on the suitability of the design and operating effectiveness of a service provider’s controls in achieving specified compliance control objectives. Examples of the service providers addressed by this SOP are investment advisers, custodians, transfer agents, administrators, and principal underwriters that provide services to investment companies, investment advisers, or other service providers.</td>
</tr>
<tr>
<td>Issue Date: October 2007 (Interpretive publication)</td>
<td></td>
</tr>
<tr>
<td>AICPA Technical Practice Aid (TPA) Technical Questions and Answers (TIS) sections 8200.05–.16 (AICPA, Technical Practice Aids)</td>
<td>These questions and answers in TIS section 8200, Internal Control, were developed in response to common questions received from members regarding the implementation of SAS Nos. 104–111. Some of the topics include</td>
</tr>
<tr>
<td>Issue Date: April and May 2008 (Nonauthoritative)</td>
<td>- consideration of internal controls that are less formal or not documented by the client.</td>
</tr>
<tr>
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<td>- whether the auditor may suggest improvements to a client’s internal control.</td>
</tr>
<tr>
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<td>- assessing inherent risk in relation to the consideration of control risk.</td>
</tr>
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<td>- the frequency of walkthroughs that are used as the basis for the auditor’s understanding of internal control.</td>
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<td>- considerations in obtaining an understanding of, evaluating, and documenting controls that the auditor believes are nonexistent or ineffective.</td>
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<tr>
<td></td>
<td>- assessing control risk at the maximum level.</td>
</tr>
<tr>
<td></td>
<td>- considerations for developing a substantive audit strategy.</td>
</tr>
<tr>
<td>TIS section 9120.08, “Part of an Audit Performed in Accordance With International Standards on Auditing” (AICPA, Technical Practice Aids)</td>
<td>This question and answer discusses the implications to the principal auditor’s report when part of an audit is conducted by other independent auditors in accordance with International Standards on Auditing or another country’s auditing standards.</td>
</tr>
<tr>
<td>Issue Date: April 2008 (Nonauthoritative)</td>
<td></td>
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<td>(continued)</td>
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</tr>
<tr>
<td>TIS section 9100.06, “The Effect of Obtaining the Management Representation Letter on Dating the Auditor’s Report” (AICPA, Technical Practice Aids)</td>
<td>This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor’s report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor’s report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that it will sign the representation letter, without exception, on or before the date of the representations.</td>
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<td>Issue Date: May 2007 (Nonauthoritative)</td>
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<tr>
<td>TIS section 8350.01, “Current Year Audit Documentation Contained in the Permanent File” (AICPA, Technical Practice Aids)</td>
<td>This question and answer discusses whether the provisions of AU section 339, Audit Documentation (AICPA, Professional Standards, vol. 1), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that AU section 339 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year’s audit report.</td>
</tr>
<tr>
<td>Issue Date: May 2007 (Nonauthoritative)</td>
<td></td>
</tr>
<tr>
<td>AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, Audit Confirmations (AICPA, Technical Practice Aids, PA sec. 16,240)</td>
<td>This practice alert is a response to practitioners’ current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics.</td>
</tr>
<tr>
<td>Revised: June 2007 (Nonauthoritative)</td>
<td></td>
</tr>
<tr>
<td>AICPA PITF PA 07-1, Dating of the Auditor’s Report and Related Practical Guidance (AICPA, Technical Practice Aids, PA sec. 16,290)</td>
<td>This practice alert provides guidance regarding application of certain provisions of AU section 339, primarily related to dating the auditor’s report.</td>
</tr>
<tr>
<td>Issue Date: January 2007 (Nonauthoritative)</td>
<td></td>
</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 6, Evaluating Consistency of Financial Statements</td>
<td>This standard and its related amendments update the auditor’s responsibilities to evaluate and report on the consistency of a company’s financial statements and align the auditor’s responsibilities with Financial Accounting Standards Board (FASB) Statement No. 154, Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3. This standard also improves the auditor reporting requirements by clarifying that the auditor’s report should indicate whether an adjustment to previously issued financial statements results from a change in accounting principles or the correction of a misstatement.</td>
</tr>
<tr>
<td>Issue Date: November 15, 2008 (Applicable to audits conducted in accordance with PCAOB standards)</td>
<td></td>
</tr>
</tbody>
</table>
**Issue Date:** July 2007  
(Applicable to audits conducted in accordance with PCAOB standards)

This standard replaces the PCAOB’s previous internal control standard, Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. This principles-based auditing standard is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company’s financial statements, and, at the same time, eliminate procedures that are unnecessary.  
Auditing Standard No. 5 is required to be used by registered audit firms for all audits of internal control over financial reporting no later than for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted and encouraged.

### PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence* (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”)  
**Issue Date:** August 2008  
(Applicable to audits conducted in accordance with PCAOB standards)

Rule 3526 requires the registered public accounting firm to:  
- describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence;  
- discuss with the audit committee of the issuer the potential effects of any relationships that could impact independence, should they be appointed as the issuer’s auditor; and  
- document the substance of these discussions. These discussions should occur at least annually.  

The board also adjusted the implementation schedule for Rule 3523 as it applies to tax services. The board agreed not to apply Rule 3523 to tax services provided on or before December 31, 2008, when those services are provided during the audit period and are completed before the professional engagement period begins. The amendments to Rule 3523 became effective August 28, 2008. The remaining provisions of Rule 3526 became effective September 30, 2008.

(continued)
| **PCAOB Rule 3525, Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting**
| (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”)
| **Issue Date:** July 2007
| (Applicable to audits conducted in accordance with PCAOB standards)  

This rule requires a registered public accounting firm that seeks preapproval of an issuer audit client’s audit committee to perform internal control-related nonaudit services that are not otherwise prohibited by the act or the rules of the Securities and Exchange Commission (SEC) or the PCAOB to describe, in writing, to the audit committee the scope of the proposed service, discuss with the audit committee the potential effects of the proposed service on the firm’s independence, and document the substance of the firm’s discussion with the audit committee. These requirements parallel the auditor’s responsibility in seeking audit committee preapproval to perform tax services for an audit client under PCAOB Rule 3524, Audit Committee Pre-approval of Certain Tax Services (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”). This rule is effective for audits of fiscal years ending on or after November 15, 2007.

| **PCAOB Conforming Amendments to the Interim Auditing Standards**
| (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)  
| **Issue Date:** November 15, 2008
| (Applicable to audits conducted in accordance with PCAOB standards)  


| **PCAOB Conforming Amendments to the Interim Auditing Standards**
| (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)  
| **Issue Date:** July 2007
| (Applicable to audits conducted in accordance with PCAOB standards)  


These amendments are effective for audits of fiscal years ending on or after November 15, 2007, the same effective date of Auditing Standard No. 5.

| **Issue Date:** January 2007
| (Applicable to audits conducted in accordance with PCAOB standards)  

This release focuses on aspects of the PCAOB’s interim auditing standards that address the auditor’s responsibility with respect to fraud, specifically AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, PCAOB Standards and Related Rules). This report does not change or propose to change any existing standard nor is the PCAOB providing any new interpretation of existing standards.
Accounting Issues and Developments

Convergence With International Financial Reporting Standards

.62 Since the signing of the Norwalk Agreement by the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB), the bodies have had a common goal—one set of accounting standards for international use. In this agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. In 2005 meetings, FASB and the IASB reaffirmed their commitment to the convergence of U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS). A common set of high quality, globally accepted standards remains the long-term strategic priority of both FASB and the IASB.

.63 FASB and the IASB have undertaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and IFRS. These ongoing joint projects address the conceptual framework, business combinations, financial statement presentation, and revenue recognition. For more information on the status of this project go to www.fasb.org and www.iasb.org.
SEC Eases Acceptance of IFRS Financial Statements

.64 On December 21, 2007, the SEC took a major step towards easing the acceptance of IFRS financial statements by adopting rules to accept from foreign private issuers financial statements prepared in accordance with IFRS as issued by the IASB without reconciliation to U.S. GAAP. This rule marks an important step in the process toward the development of a single set of high quality, globally accepted accounting standards. This rule became effective March 4, 2008. Readers can access this rule at www.sec.gov/rules/final/2007/33-8879.pdf.

.65 More than 100 countries now either require or allow the use of IFRS for the preparation of financial statements by listed companies, and additional countries are moving to do the same. This recent movement to IFRS outside the United States has resulted in an increase of filings with the SEC of foreign private issuers that represent in the footnotes to their financial statements that their financial statements comply with IFRS as published by the IASB—from a relative few in 2005 to approximately 110 in 2006. The SEC expects this number will continue to increase in the future, particularly pursuant to Canada’s announced move to IFRS, as there currently are approximately 500 foreign private issuers from Canada.

.66 This movement to IFRS also has begun to affect U.S. issuers, in particular those with a significant global footprint. For instance, certain U.S. issuers may compete for capital globally in industry sectors in which a critical mass of non-U.S. companies report under IFRS. Also, U.S. issuers with subsidiaries located in jurisdictions that have moved to IFRS may prepare those subsidiaries’ financial statements in IFRS for purposes of local regulatory or statutory filings. Readers should remain alert to developments regarding convergence.

IFRS “Roadmap”

.67 On August 27, 2008, the SEC voted to publish for public comment a proposed roadmap that could lead to the use of IFRS by U.S. issuers beginning in 2014. The SEC would make a decision in 2011 on whether adoption of IFRS is in the public interest and would benefit investors. The proposed multiyear plan sets out several milestones that, if achieved, could lead to the use of IFRS by U.S. issuers in their filings with the SEC.

.68 The top 20 companies in each industry, as determined by market capitalization, could elect to begin filing IFRS financial statements for fiscal periods ending after December 15, 2009. If, in 2011, the SEC adopts IFRS for all filers, the roadmap suggests mandatory filing for large accelerated filers beginning in 2014, accelerated filers in 2015, and nonaccelerated filers in 2016.

.69 The 60-day comment period will begin when the proposed roadmap is published in the federal register.

.70 Additionally, in the spotlight section of its Web site, the SEC provides information on the following topics and groups:

- SEC roundtable on IFRS held on August 4, 2008
- SEC roundtable on practical issues surrounding the use of IFRS in the United States in recent years, and the potential expanded use of IFRS in future years
- SEC roundtable on IFRS in the U.S. markets held on December 13, 2007
- Proposed rulemaking and request for public comments
- SEC staff roundtable on IFRS roadmap
- SEC press releases
- Staff review of financial statements prepared in accordance with IFRS
- Speeches and public statements
This information can be accessed at www.sec.gov/spotlight/ifrsroadmap.htm.

**AICPA Launches IFRS.com Web Site to Inform Members and Financial Professionals About International Accounting Standards**

The AICPA is calling for an orderly transition and reasonable time frame of three to five years for the U.S. accounting profession to adopt IFRS. During a FASB forum on June 16, 2008, held to facilitate an open dialogue about whether and how to move the U.S. financial reporting system to IFRS and define next steps in that process, it was noted that awareness of IFRS is growing, but most believe it will take three to five years to prepare.

To assist in both awareness building and education, the AICPA launched a new Web site, www.ifrs.com, in May 2008. The site provides current information about developments in international convergence. The growing acceptance of IFRS as a basis for U.S. financial reporting represents a fundamental change for the U.S. accounting profession. Acceptance of a single set of high-quality accounting standards for worldwide use by public companies has been gaining momentum around the globe over the past few years.

Developed by the AICPA, in partnership with its marketing and technology subsidiary, CPA2Biz, the goal of IFRS.com is to provide a comprehensive set of resources for accounting professionals, auditors, financial managers, audit committees and other users of financial statements.

The Web site features tools and resources to help CPAs get acquainted with IFRS, the surrounding issues and available support. Resources include a history of convergence, a high-level overview of the differences between IFRS and U.S. GAAP, frequently asked questions, articles, textbooks, CPE courses and live conference training, helpful links and assistance for audit committee members.

**FASB Accounting Standards Codification™**

On January 15, 2008, FASB launched the one-year verification period of FASB Accounting Standards Codification™ (ASC). FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing all authoritative literature in a topically organized structure. FASB ASC includes all accounting standards issued by a standard setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, AICPA, Emerging Issues Task Force (EITF), and related literature. FASB ASC also includes relevant authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance.

The purpose of FASB ASC is not to change GAAP, but rather to reorganize thousands of GAAP pronouncements into approximately 90 topics. At the end of the one-year verification period, FASB is expected to formally approve the FASB ASC as the single source of authoritative U.S. accounting and reporting standards, other than guidance issued by the SEC. At that time, FASB will supersede all then-existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the FASB ASC will become nonauthoritative. FASB expects to approve FASB ASC in April 2009. FASB ASC can be accessed at asc.fasb.org/home.

 Constituents are encouraged to use FASB’s online FASB ASC Research System free of charge and provide feedback to FASB on the codification.

The AICPA has published the Financial Reporting Alert *FASB Codification Developments—2008* (product no. 029209kk). This Financial Reporting Alert is intended to provide a better understanding of FASB ASC, outline its structure, as well as provide case studies on navigating FASB ASC Research System and performing accounting research.
Accounting for Collaborative Arrangements

.80 Companies may enter into arrangements with other companies to jointly develop, manufacture, distribute, and market a product or provide a service. Often the activities associated with these arrangements are conducted by the collaborators without creating a separate legal entity (that is, the arrangement is operated as a virtual joint venture). For example, two not-for-profit health care systems may enter into a joint operating agreement whereby both parties agree to jointly operate and control certain of their hospitals. The arrangements generally provide that the collaborators will share, based on contractually defined calculations, the profits or losses from the associated activities.

.81 Questions have arisen in practice as to the appropriate presentation and classification of these activities in the income statement (for example, report revenues generated and costs incurred on a gross basis within the financial statements, report the net amount of revenue and expenses in the revenue line item or as a contra-expense, or report the activities of the arrangement as if it were a joint venture).

.82 At its November 29, 2007, meeting, the EITF reached consensus on EITF Issue No. 07-1, “Accounting for Collaborative Arrangements.” This consensus requires participants in a collaborative arrangement to present the results of activities for which they act as the principal on a gross basis and to report any payments received from (or made to) other collaborators based on other applicable GAAP or, in the absence of other applicable GAAP, based on analogy to authoritative literature or a reasonable, rational, and consistently applied accounting policy election.

.83 The consensus permits payments between collaborators to be “grossed up” into component parties in the income statement (for example, amounts due from one party could be presented separately from amounts due to the other party, even if only one net payment was made). For those entities that followed the guidance in the AICPA’s Technical Practice Aid Technical Questions and Answers (TIS) section 6400.33, “Accounting for a Joint Operating Agreement” (AICPA, Technical Practice Aids) this consensus may have significant implications: Joint operating agreements between two not-for-profit health care systems should be accounted for by using the equity method of accounting (similar to a corporate joint venture).

.84 The consensus prohibits using the equity method of accounting for collaboration arrangements unless a new legal entity is formed. It also requires significant disclosures related to material collaborative arrangements.

.85 Effective for annual periods beginning after December 15, 2008, the consensus should be applied retrospectively for collaborative arrangements existing at the effective date of the consensus as a change in accounting principle.

Accounting for Certain Real Estate Transactions

.86 Health care organizations continue to monetize noncore assets (such as medical office buildings) through sale-leaseback transactions and enter into agreements with developers to construct assets in which the organization will lease space (build-to-suit transactions). In both cases, the health care organization might believe the transaction will be off-balance sheet. Yet the accounting requirements for these transactions (contained primarily in FASB Statement No. 66, Accounting for Sales of Real Estate; FASB Statement No. 98, Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases—an amendment of FASB Statements No. 13, 66, and 91 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11; and EITF Issue No. 97-10, “The Effect of Lessee Involvement in Asset Construction”), are extremely restrictive and should be consulted before entering into any agreements or before starting any construction activity, including site preparation.

.87 When evaluating these or other real estate transactions, health care organizations also should consider the guidance contained in EITF Issue No. 01-8, “Determining Whether an Arrangement Contains
a Lease,” to determine if lease accounting may be required when the organization has the right to use property and equipment.

**Expiration of Donor-Imposed Restrictions**

.88 Paragraph 17 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, requires that a not-for-profit organization recognize the expiration of a donor-imposed restriction on a contribution in the period in which the restriction expires. A purpose restriction expires when the stipulated purpose for which the resource was restricted has been fulfilled. FASB Statement No. 116 goes on to note that if an expense is incurred for a purpose for which both restricted and unrestricted net assets are available, the donor-imposed restriction is considered fulfilled to the extent of the expense incurred (the “first-dollar” rule). In the past, many not-for-profit health care organizations and their related fund-raising foundations may not have carefully monitored the status of temporarily restricted donations that were received in previous years. In many cases, the donor’s restrictions on those funds have been fulfilled based on the first-dollar rule (and therefore, the net assets should have been reclassified from temporarily restricted to unrestricted net assets).

.89 Organizations should evaluate the status of their restricted funds to determine if they are appropriately classified in the financial statements. In addition, given the requirements of FASB Statement No. 116 and the first-dollar rule, development personnel may wish to reconsider the processes used to solicit donor contributions to ensure that the donor’s true intent is clearly documented.

**Omnibus Changes to Consolidation and Equity Method Guidance for Not-for-Profit Organizations**

.90 In May 2008, FASB issued FASB Staff Position (FSP) SOP 94-3-1 and AAG HCO-1, *Omnibus Changes to Consolidation and Equity Method Guidance for Not-for-Profit Organizations*. This FSP makes several changes to the guidance on consolidation and the equity method of accounting in AICPA Statement of Position (SOP) 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (AICPA, Technical Practice Aids, ACC sec. 10,610), and the AICPA Audit Accounting Guide *Health Care Organizations*. Specifically, SOP 94-3-1,

- eliminates the temporary control exception to consolidation that currently exists for certain relationships between not-for-profit organizations.
- confirms the continued applicability to not-for-profit organizations of the consensus guidance on consolidation of special-purpose lessors in EITF Issue No. 90-15, “Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions”; No. 96-21, “Implementation issues in Accounting for Leasing Transactions involving Special-Purpose Entities”; and No. 97-1, “Implementation Issues in Accounting for Lease Transactions, Including Those Involving Special-Purpose Entities.”
- requires that not-for-profit organizations apply the guidance in AICPA SOP 78-9, *Accounting for Investments in Real Estate Ventures* (AICPA, Technical Practice Aids, ACC sec. 10,240); EITF Issue No. 03-16, “Accounting for Investments in Limited Liability Companies”; and FSP SOP 78-9-1, *Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5*, for investments in for-profit partnerships and limited liability companies in which they have more than a minor interest unless they carry those investments at fair value. This change is not expected to have a significant impact on not-for-profit health care organizations.

The guidance in the FSP is effective for fiscal years beginning after June 15, 2008, and interim periods therein.

**Summary of Recent Accounting Pronouncements and Related Guidance**

.91 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. This alert is intended to be used in conjunction with AICPA Comprehensive Audit Risk Alert—2008 (product no. 022339kk); therefore, only industry specific pronouncements and related guidance or those of specific significance to the industry are summarized herein. For information on accounting standards issued...
subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the CPA Letter and Journal of Accountancy.

### Recent Accounting Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Statement No.</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>FASB 163</td>
<td>Accounting for Financial Guarantee Insurance Contracts—an interpretation of FASB Statement No. 60 (May 2008)</td>
</tr>
<tr>
<td>FASB 162</td>
<td>The Hierarchy of Generally Accepted Accounting Principles (May 2008)</td>
</tr>
<tr>
<td>FASB 161</td>
<td>Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133 (March 2008)</td>
</tr>
<tr>
<td>FASB 160</td>
<td>Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51 (December 2007)</td>
</tr>
<tr>
<td>FASB 141</td>
<td>Business Combinations (December 2007)</td>
</tr>
<tr>
<td>FASB 159</td>
<td>The Fair Value Option for Financial Assets and Financial Liabilities—including an amendment of FASB Statement No. 115 (February 2007)</td>
</tr>
<tr>
<td>FASB 158</td>
<td>Business Combinations (September 2006)</td>
</tr>
<tr>
<td>FASB 157</td>
<td>Fair Value Measurements (September 2006)</td>
</tr>
<tr>
<td>FASB FIN 48</td>
<td>Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109 (June 2006)</td>
</tr>
<tr>
<td>FASB Staff Position (FSP) FIN 48-2</td>
<td>Defers the effective date of FIN 48 for certain nonpublic enterprises, as defined in the FSP, to the annual financial statements for fiscal years beginning after December 15, 2007.</td>
</tr>
<tr>
<td>FASB EITF Issues</td>
<td>Go to <a href="http://www.fasb.org/eitf/agenda.shtml">www.fasb.org/eitf/agenda.shtml</a> for a complete list of EITF Issues.</td>
</tr>
<tr>
<td>FASB Staff Positions</td>
<td>Go to <a href="http://www.fasb.org/fasb_staff_positions/">www.fasb.org/fasb_staff_positions/</a> for a complete list of FSPs.</td>
</tr>
</tbody>
</table>
AICPA SOP 07-1 (AICPA, Technical Practice Aids, ACC sec. 10,950)  | Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies
---|---
In February 2008, FASB issued FSP SOP 07-1-1, Effective Date of AICPA Statement of Position 07-1, which indefinitely defers the effective date of SOP 07-1. Entities that early adopted SOP 07-1 before December 15, 2007 are permitted, but not required, to continue to apply the provisions of the SOP. No other entities may adopt the provision of the SOP, subject to the exception in the following sentence: if a parent entity that early adopted the SOP chooses not to rescind its early adoption, an entity consolidated by the parent entity that is formed or acquired after that parent entity’s adoption of the SOP must apply the provisions of the SOP in its stand-alone financial statements.

TIS sections 6910.25–.28 (AICPA, Technical Practice Aids)  | These questions and answers discuss financial statement presentation considerations for investment companies.
(Nonauthoritative)  |  
TIS sections 6140.20–.22 (AICPA, Technical Practice Aids)  | These questions and answers discuss not-for-profit organizations fund-raising expenses.
(Nonauthoritative)  |  
TIS section 6931.08–.10 (AICPA, Technical Practice Aids)  | These questions and answers discuss various employee benefit plan topics.
(Nonauthoritative)  |  
AICPA Practice Guide  | Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48
(Nonauthoritative)  |  

.92 The AICPA Comprehensive Audit Risk Alert—2008 and other AICPA industry-specific alerts also contain summaries of recent pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or visit www.cpa2biz.com.

Recent AICPA Independence and Ethics Pronouncements

.93 AICPA Independence and Ethics Alert—2007/08 (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

On the Horizon

.94 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to the health care industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.
The following table lists the various standard-setting bodies’ Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.

<table>
<thead>
<tr>
<th>Standard-Setting Body</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>AICPA Auditing Standards Board (ASB)</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/</a></td>
</tr>
<tr>
<td>Financial Accounting Standards Board (FASB)</td>
<td><a href="http://www.fasb.org">www.fasb.org</a></td>
</tr>
<tr>
<td>Governmental Accounting Standards Board (GASB)</td>
<td><a href="http://www.gasb.org">www.gasb.org</a></td>
</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
<td><a href="http://www.pcaob.org">www.pcaob.org</a></td>
</tr>
<tr>
<td>Professional Ethics Executive Committee (PEEC)</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/">www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/</a></td>
</tr>
</tbody>
</table>

Overhaul Project—AICPA Audit and Accounting Guide *Health Care Organizations*

The AICPA is continuing to make progress overhauling the AICPA Audit and Accounting Guide *Health Care Organizations*, addressing numerous accounting, auditing, industry, and regulatory issues that have transpired since this guide was originally issued in 1996. During this project, the AICPA will continue to issue annual editions of the guide, updated to reflect recent audit and accounting pronouncements.

**Auditing Pipeline—Nonissuers**

**ASB Clarity Project**

The Auditing Standards Board (ASB) formed a Clarity Task Force to address concerns over the clarity, length, and complexity of generally accepted auditing standards. In March 2007, the ASB approved for exposure a discussion paper *Improving the Clarity of ASB Standards*. Over the next two to three years, the ASB will be redrafting all of the existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU sections of the AICPA’s *Professional Standards*), to apply the clarity drafting conventions and to converge with the International Standards on Auditing issued by the International Auditing and Assurance Standards Board. The ASB proposes that, except to address current issues, all redrafted standards will become effective at the same time. Only those standards needing to address current issues would have earlier effective dates. The ASB believes that a single effective date will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. Currently, the date is expected to be for audits of financial statements for periods beginning no earlier than December 15, 2010. This date depends on satisfactory progress being made, and will be amended should that prove necessary. See the *Clarity Project Explanatory Memorandum* and the discussion paper *Improving the Clarity of ASB Standards* at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm.
Auditing Pipeline—Issuers

.98 Guidance issued by the PCAOB is included in the section of this alert titled “Summary of Recent Auditing and Attestation Pronouncements and Related Guidance.” For more information regarding recent developments at both the SEC and PCAOB, readers may refer to Audit Risk Alert SEC and PCAOB Developments—2008.

Accounting Pipeline

.99 There are a number of accounting projects and pronouncements currently in progress. For a summary of significant accounting projects and pronouncements, refer to AICPA Comprehensive Audit Risk Alert—2008 (product no. 022339kk). Such in progress issues include the following:

- Accounting for hedging activities exposure draft
- Accounting for contingencies exposure draft
- Phase 2 of the fair value project
- Transfers of financial assets project
- Earnings per share convergence project
- Income tax convergence project

Uniform Prudent Management of Institutional Funds Act

.100 In February 2008, FASB released for public comment proposed FSP FAS 117-a, Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures. If approved as proposed, the FSP would

- provide guidance on the net asset classification of donor-restricted endowment funds for not-for-profit organizations that are subject to an enacted version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA). (As of February 1, 2008, 13 states and the District of Columbia had enacted a version of UPMIFA, with legislation pending in several other states.)
- improve disclosures about an organization’s endowment funds (both donor-restricted and funds functioning as endowments), whether or not the organization is subject to UPMIFA.

The FSP would be effective for fiscal years ending after June 15, 2008, with earlier application permitted.

.101 The first, and perhaps most significant question the proposed FSP addresses is how UPMIFA’s elimination of the historic-dollar-value threshold—the amount below which an organization could not spend under the Uniform Management of Institutional Funds Act (UMIFA)—affects net asset classification. The proposed FSP would require an organization to classify a portion of a donor-restricted endowment fund (other than a term endowment) as permanently restricted net assets. That portion would be equal to the amount of the fund (a) that must be retained permanently in accordance with explicit donor stipulations, or (b) that in the absence of such stipulations, the organization’s governing board determines must be retained permanently under the relevant law. The organization would be required to disclose its interpretation of the law.

.102 It is anticipated that discussions among organizations, accountants, attorneys, and regulators in the various states may lead to consensus in those states determining what must be retained permanently under the law. If a governing board determines that the law requires maintenance of purchasing power of a donor’s gift, the organization would increase permanently restricted net assets to the extent that the purchasing power of a dollar decreases or decrease permanently restricted net assets to the extent that the purchasing power of a dollar increases. (This would typically be done by adjusting permanently restricted net assets by an appropriate inflationary factor, such as the consumer price index or higher education price index.)
In contrast, an organization would not subsequently decrease permanently restricted net assets because of investment losses or organizational spending from the endowment, but would instead decrease temporarily restricted net assets, if available, or unrestricted net assets. The guidance on investment losses and spending is consistent with the guidance previously provided on investment losses in paragraph 12 of FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*. FASB considered but decided not to change that guidance, noting that permanently restricted net assets should reflect the amount for which an organization has a permanent fiduciary duty and not the amount that it has on hand at a financial statement date because of cumulative investment and spending decisions.

The proposed FSP also addresses whether two other provisions in UPMIFA’s endowment spending guidelines impose temporary (time) restrictions on the portion of a donor-restricted endowment fund that would otherwise be considered unrestricted net assets:

- A provision that “[u]nless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution”
- An optional provision for a rebuttable presumption that spending more than 7 percent of endowment market value is imprudent (Some states have included this provision.)

The FSP would require organizations to apply the guidance previously provided in EITF Topic No. D-49, “Classifying Net Appreciation on Investments of a Donor-Restricted Endowment Fund,” included as an appendix to the FSP. EITF Topic No. D-49 stresses that not all legal restrictions on the use of particular assets result in restricted net assets for accounting purposes, only those that extend donor restrictions. An example of the latter would be a requirement to maintain the purchasing power of a donor’s endowment gift.

Laws that refer to actions entirely within the purview of a governing board, such as acting to appropriate funds or exercising prudence do not, alone, extend donor-imposed restrictions. The FSP contains the important caveat that, in applying the guidance in EITF Topic No. D-49, an organization would need to look at the actual wording in the specific version of UPMIFA (and other relevant laws) to which the organization is subject.

The other key provisions of the proposed FSP focus on improving endowment disclosures, both donor-restricted and board-designated. Aiming to improve transparency about endowments in an era of increased public scrutiny, the proposed FSP focuses on disclosures in four areas:

- Net asset classification (especially how that is affected by a governing board’s interpretation of relevant law)
- Spending policies
- Investment policies (especially their relationship with spending policies)
- Net asset composition and changes therein (especially the relationship of endowment spending to endowment size and growth)

Proposed FASB EITFs and FSPs

Proposed FASB EITF Issues. Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

Proposed FSPs. A number of other proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

Resource Central

The following are various resources that practitioners engaged in the health care industry may find beneficial.
Publications

.111 Practitioners may find the following publications useful. Choose the format best for you—online, print, or CD-ROM.

- Audit and Accounting Guide *Health Care Organizations* (2008) (product no. 012618kk [paperback], WHC-XX [online with the associated Audit Risk Alert], or DHC-XX [CD-ROM with the associated Audit Risk Alert])
- Audit and Accounting Guide *Not-for-Profit Organizations* (2008) (product no. 012648 [paperback], WNP-XX [online with the associated Audit Risk Alert], or DNP-XX [CD-ROM with the associated Audit Risk Alert])
- Audit Guide *Analytical Procedures* (2008) (product no. 012558kk [paperback], WAN-XX [online], or DAN-XX [CD-ROM])
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2008) (product no. 012528kk [paperback], WDI-XX [online], or DDI-XX [CD-ROM])
- Audit Guide *Auditing Revenue in Certain Industries* (2008) (product no. 012518kk [paperback], WAR-XX [online], or DAR-XX [CD-ROM])
- Audit Guide *Audit Sampling* (2008) (product no. 012538kk [paperback], WAS-XX [online], or DAS-XX [CD-ROM])
- Audit Guide *Government Auditing Standards and Circular A-133 Audits* (2008) (product no. 012748kk [paperback], WRF-XX [online with the associated Audit Risk Alert], or DRF-XX [CD-ROM with the associated Audit Risk Alert])
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2008) (product no. 012778kk [paperback], WSV-XX [online], or DSV-XX [CD-ROM])
- AICPA Comprehensive Audit Risk Alert—2008 (product no. 022339kk [paperback], WGE-XX [online], or DGE-XX [CD-ROM])
- Audit Risk Alert *Independence and Ethics—2008* (product no. 022479kk [paperback], WIA-XX [online], or DIA-XX [CD-ROM])
- Audit Risk Alert *SEC and PCAOB Developments—2008* (product no. 022499kk [paperback])
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk [paperback])
- Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk [paperback], or 022536PDF [downloadable PDF])
- Checklists and Illustrative Financial Statements for Health Care Organizations (product no. 009028kk [paperback], or WHE-CL [online])
- Audit and Accounting Manual (2008) (product no. 005138kk [paperback], WAM-XX [online], or AAM-XX [loose leaf])
- Accounting Trends & Techniques, 62nd Edition (product no. 009900kk [paperback] or WAT-XX [online])

.112 Additional resources for accountants in business and industry are the Financial Reporting Alert series, designed to be used by members of an entity’s financial management and audit committee to identify and understand current accounting and regulatory developments affecting the entity’s financial reporting.

- Financial Reporting Alert *Current Accounting Issues and Risks—2008* (product no. 029208kk)
- Financial Reporting Alert *Not-for-Profit Organizations—Accounting Issues and Risks 2008* (product no. 029207kk)
AICPA reSOURCE: Accounting and Auditing Literature

.113 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm’s needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to the AICPA’s latest Professional Standards, Technical Practice Aids, Audit and Accounting Guides (more than 20), Audit Risk Alerts (more than 15), and Accounting Trends & Techniques. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Continuing Professional Education

.114 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

• AICPA’s Annual Accounting and Auditing Update Workshop (2008–2009 Edition) (product no. 736184kk [text] or 187192kk [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.

• SEC Reporting (product no. 736775kk [text] or 186756kk [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.

• International Versus U.S. Accounting: What in the World is the Difference? (product no. 731666 [text]). With the fast pace of the convergence project, understanding the differences between IFRS and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRS and U.S. GAAP.

• The International Financial Reporting Standards: An Overview (product no. 157220 [online] or 739750HS [DVD]). This course captures a live presentation on IFRS given to the AICPA Board of Directors. Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.115 AICPA CPEExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz, is AICPA’s flagship online learning product. AICPA members pay $180 for a new subscription and $149 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPEExpress offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com.

Webcasts

.116 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession’s leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.117 The CFO Quarterly Roundtable Series, brought to you each calendar quarter via webcast, covers a broad array of “hot topics” that successful organizations employ and subjects that are important to the CFO’s personal success. From financial reporting, budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.
SEC Quarterly Update Series

The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession’s leading experts on what is “hot” at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you “plugged in” to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA’s Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. Beginning January 14, 2008, hotline hours were extended so that the hotline is now available from 9 a.m. to 8 p.m. on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help.

Ethics Hotline

In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA’s Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077.

Industry Conference

The AICPA offers an annual Health Care Conference in the fall. The National Health Care Conference is a three-day conference designed to update attendees on recent developments related to the health care industry. The National Health Care Industry Conference is an unparalleled opportunity to gain the information and techniques you need to know to stay on top of trends to benefit your practice and your client offerings. With access to some of the nation’s top health care specialists, you’ll get up-to-the-minute information on the latest developments in health care issues. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

AICPA Governmental Audit Quality Center

The Governmental Audit Quality Center (GAQC) is a firm-based, voluntary membership center designed to help CPAs meet the challenges of performing quality audits in this unique and complex area. The GAQC’s primary purpose is to promote the importance of quality governmental audits and the value of such audits to purchasers of governmental audit services. The GAQC also offers resources to enhance the quality of a firm’s governmental audits.

The mission of the GAQC is to do the following:

- Raise awareness about the importance of governmental audits.
- Serve as a comprehensive resource provider on governmental audits for member firms.
- Create a community of firms that demonstrates a commitment to governmental audit quality.
• Provide center members with an online forum tool for sharing best practices and discussing audit, accounting, and regulatory issues.

• List member firms to enable purchasers of governmental audit services to identify firms that are members.

• Provide information about the center’s activities to other governmental audit stakeholders.

.125 For more information about the GAQC, visit http://gaqc.aicpa.org.

The Center for Audit Quality

.126 The Center for Audit Quality (CAQ), which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ’s mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession’s core values of integrity, objectivity, honesty, and trust.

.127 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit http://thecaq.aicpa.org.

AICPA Industry Expert Panel—Health Care

.128 For information about the activities of the AICPA Health Care Industry Expert Panel, visit the panel’s Web page at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_healthcare.htm.

Industry Web Sites

.129 The Internet covers a vast amount of information that may be valuable to auditors of health care organizations, including current industry trends and developments. Some of the more relevant sites for auditors with health care clients include those shown in the following table:

<table>
<thead>
<tr>
<th>Organization</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>Healthcare Financial Management Association</td>
<td><a href="http://www.hfma.org">www.hfma.org</a></td>
</tr>
<tr>
<td>The Catholic Health Association of the United States</td>
<td><a href="http://www.chausa.org">www.chausa.org</a></td>
</tr>
<tr>
<td>Federation of American Hospitals</td>
<td><a href="http://www.americashospitals.com">www.americashospitals.com</a></td>
</tr>
<tr>
<td>Centers for Medicare and Medicaid Services</td>
<td><a href="http://www.cms.hhs.gov">www.cms.hhs.gov</a></td>
</tr>
<tr>
<td>U.S. Department of Health and Human Services</td>
<td><a href="http://www.hhs.gov">www.hhs.gov</a></td>
</tr>
<tr>
<td>Global Health Reporting</td>
<td><a href="http://www.globalhealthreporting.org">www.globalhealthreporting.org</a></td>
</tr>
<tr>
<td>Kaiser Family Foundation</td>
<td><a href="http://www.kff.org">www.kff.org</a></td>
</tr>
<tr>
<td>Atlantic Information Services</td>
<td><a href="http://www.aishealth.com">www.aishealth.com</a></td>
</tr>
</tbody>
</table>
.130 The health care practices of some of the larger CPA firms may also contain industry-specific auditing and accounting information that is helpful to auditors.

* * * *

.131 This Audit Risk Alert replaces Health Care Industry Developments—2007/08.

.132 The Audit Risk Alert Health Care Industry Developments is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year’s Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to zdonahue@aicpa.org or write to

Zachary T. Donahue, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110
Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

<table>
<thead>
<tr>
<th>Web Site Name</th>
<th>Content</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>American Institute of CPAs (AICPA)</td>
<td>Summaries of recent auditing and other professional standards as well as other AICPA activities</td>
<td><a href="http://www.aicpa.org">www.aicpa.org</a>, <a href="http://www.cpa2biz.com">www.cpa2biz.com</a>, <a href="http://www.ifrs.com">www.ifrs.com</a></td>
</tr>
<tr>
<td>AICPA Accounting Standards Executive Committee (AcSEC)</td>
<td>Issues guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards</a></td>
</tr>
<tr>
<td>AICPA Accounting and Review Services Committee (ARSC)</td>
<td>Develops and issues review and compilation standards and interpretations</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee</a></td>
</tr>
<tr>
<td>AICPA Professional Issues Task Force (PITF)</td>
<td>Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force</a></td>
</tr>
<tr>
<td>Economy.com</td>
<td>Source for analyses, data, forecasts, and information on the United States and world economies</td>
<td><a href="http://www.economy.com">www.economy.com</a></td>
</tr>
<tr>
<td>The Federal Reserve Board</td>
<td>Key interest rates</td>
<td><a href="http://www.federalreserve.gov">www.federalreserve.gov</a></td>
</tr>
<tr>
<td>Financial Accounting Standards Board (FASB)</td>
<td>Summaries of recent accounting pronouncements and other FASB activities</td>
<td><a href="http://www.fasb.org">www.fasb.org</a></td>
</tr>
<tr>
<td>USA.gov</td>
<td>Portal through which all government agencies can be accessed</td>
<td><a href="http://www.usa.gov">www.usa.gov</a></td>
</tr>
<tr>
<td>Governmental Accounting Standards Board (GASB)</td>
<td>Summaries of recent accounting pronouncements and other GASB activities</td>
<td><a href="http://www.gasb.org">www.gasb.org</a></td>
</tr>
<tr>
<td>International Accounting Standards Board (IASB)</td>
<td>Summaries of International Financial Reporting Standards and International Accounting Standards</td>
<td><a href="http://www.iasb.org">www.iasb.org</a></td>
</tr>
<tr>
<td><strong>Web Site Name</strong></td>
<td><strong>Content</strong></td>
<td><strong>Web Site</strong></td>
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<td>---------------</td>
</tr>
<tr>
<td>International Auditing and Assurance Standards Board (IAASB)</td>
<td>Summaries of International Standards on Auditing</td>
<td><a href="http://www.iaasb.org">www.iaasb.org</a></td>
</tr>
<tr>
<td>International Federation of Accountants (IFAC)</td>
<td>Information on standards setting activities in the international arena</td>
<td><a href="http://www.ifac.org">www.ifac.org</a></td>
</tr>
<tr>
<td>Private Company Financial Reporting Committee (PCFRC)</td>
<td>Information on the initiative to further improve FASB’s standard setting process to consider needs of private companies and their constituents of financial reporting.</td>
<td><a href="http://www.pcfr.org">www.pcfr.org</a></td>
</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
<td>Information on accounting and auditing activities of the PCAOB and other matters</td>
<td><a href="http://www.pcaob.org">www.pcaob.org</a></td>
</tr>
</tbody>
</table>

[The next page is 8121.]
AAM Section 8040

Insurance Industry Developments—2008

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of insurance industry entities with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an other auditing publication as defined in AU section 150, Generally Accepted Auditing Standards (AICPA, Professional Standards, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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RSM McGladrey Inc.

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your insurance industry audits. This alert can also be used by an entity’s internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool in helping you identify the significant risks that may result in the material misstatement of financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This alert is intended to be used in conjunction with the Comprehensive Audit Risk Alert—2008 (product no. 022339kk). This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.03 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor’s understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity’s financial performance
- Internal control, which includes the selection and application of accounting policies

.04 The insurance industry may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.05 The auditor should obtain an understanding of the entity’s objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity’s ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity’s business is also dynamic, and the entity’s strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.06 After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

.07 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client’s environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.
Economic and Industry Developments

The State of the Economy

.08 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on the entity’s financial statements being audited.

.09 In September 2008, unprecedented events occurred in the financial markets, including the failure of a major investment bank, acquisitions of several investment and commercial banks (including some that required assistance from federal agencies), and the placement of Fannie Mae and Freddie Mac into conservatorship. Further, several foreign financial institutions received assistance from their national governments or entered into similar acquisition agreements. Additionally, on September 17, 2008, a significant publicly-registered money market fund declined below the industry standard of $1.00 per share on a market value basis due to a combination of holdings of short-term securities issued by the failed investment bank and major shareholder redemptions. As a result of these events, the condition of the fixed income markets worsened, and corporations and financial institutions generally recognized as creditworthy began experiencing difficulty borrowing money in the financial markets for any period of time longer than an overnight basis.

.10 In response, the U.S. Senate and, on October 3, 2008, the U.S. House of Representatives passed a bill that, among other things, appropriated up to $700 billion to purchase various forms of asset-backed securities and made a number of changes to the Internal Revenue Code. The repercussions of these events are just beginning to be felt in the wider economy. How they will affect the financial markets in the fourth quarter of 2008 is difficult to predict.

.11 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.2 percent in 2007. According to 2008 third quarter final advance estimates, real GDP decreased at an annual rate of 0.3 percent, which is down significantly from the 2.8 percent increase in real GDP during the second quarter of 2008.

.12 The unemployment rate remained relatively unchanged during 2007, holding between 4.4 percent and 5.0 percent, with an annual average rate of 4.6 percent. However, during 2008, the unemployment rate has risen. As of October 2008, the unemployment rate was 6.5 percent, representing approximately 10.1 million people.

.13 The target for the federal funds rate remained stable at 5.25 percent from June 2006 to September 2007 when the Federal Reserve began decreasing rates. Since the first rate decrease in September 2007, the Federal Reserve has decreased rates a total of 4.25 percentage points to 1.0 percent as of the end of October 2008. The Federal Reserve noted in its October press release that the pace of economic activity appears to have slowed markedly, owing importantly to a decline in consumer expenditures. Business equipment spending and industrial production have weakened in recent months, and slowing economic activity in many foreign economies is damping the prospects for U.S. exports. Moreover, the intensification of financial market turmoil is likely to exert additional restraint on spending, partly by further reducing the ability of households and businesses to obtain credit. Inflation has been high, but the Federal Open Market Committee, which sets the nation’s monetary policy, believes that the decline in energy and other commodity prices and the weaker prospects for economic activity have reduced the upside risks to inflation.
Industry Trends and Conditions

Life and Health Insurance Industry

.14 Over the past several years, life insurance companies have focused on products meant to accumulate wealth. Individual annuities compose the largest component of industry premiums and profits. As a result of an aging population, concerns about the viability of the social security system, and the shifting responsibility from employers to employees for retirement funds, life insurance companies are increasing the focus on products that ensure that an individual will not outlive his or her wealth. The early versions of these products were minimum guarantee products offered with variable annuities. The more recent focus includes variations on those minimum guarantee products as well as products that focus on longevity, liquidity, and retirement medical or long-term care expenses. Life insurers have responded to these challenges by offering creative financial options in addition to traditional mortality, morbidity, and investment returns as a part of basic product offerings.

.15 Through the end of 2008, U.S. life and annuity companies face an increasingly complex economic environment, with negative operating and net income trends and continuing adverse capital market conditions. In the midst of failing financial institutions and U.S. government intervention, financial flexibility remains diminished. The following points illustrate how significant realizable capital erosion remains a major risk, both from a ratings and an operating perspective:

- Six month 2008 net income for the major U.S. publicly traded life and annuity companies included in A.M. Best Research’s report was down 63 percent from a year earlier, whereas net operating income fell 16 percent.
- Sales of individual variable annuities through the first six months were down 12.5 percent, whereas sales of individual fixed annuities were up 34.2 percent.
- Investment risk remains heightened as asset prices continue to fall and more write-downs are likely.
- Merger and acquisition activity has slowed.

.16 Certain important elements, especially in this time of increased market volatility, may affect an auditor’s risk assessment including, but not limited to, the following:

- Due to the continued decline in the market, there is an increased emphasis on accounting for and proper disclosure of other-than-temporary-impairments of debt and equity investments. Auditors should refer to Financial Accounting Standards Board (FASB) Staff Position (FSP) FAS 115-1/FAS 124-1, The Meaning of Other-Than-Temporary-Impairment and Its Application to Certain Investments, and FASB Emerging Issues Task Force (EITF) Issue No. 99-20, “Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets,” for assistance in evaluating a company’s assessment of whether an impaired investment is other-than-temporarily impaired.
- It has become increasingly difficult to obtain input for determining the fair value of auction rate securities, money market funds, commercial paper, mortgage-backed or other asset-backed securities, collateralized debt obligations, and municipal securities due to the slowdown in trading caused by the current market. Auditors should refer to FSP FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active, for help in clarifying the application of FASB Statement No. 157, Fair Value Measurements, in a market that is not active.
- Due to the significant upheaval in the current market, auditors should pay particular attention to the company’s liquidity and capital resources, and whether the current conditions could affect the company’s ability to continue as a going concern.
- Limited historical or market policyholder behavior experience to be utilized by companies in pricing and reserving for recently issued policyholder financial options continues to affect the comparability of valuation among competitors and the availability of reinsurance capacity. (The

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availability of reinsurance is beginning to loosen; see further discussion on reinsurance in the sections of this alert entitled “Reinsurance Arrangements” and “NAIC Reinsurance Disclosure and Filing Requirements.”

- Application of a statutory principles-based approach to reserving for no-lapse guarantees is still a few years away and, as a result, large excess reserving needs remain for many of these contracts, causing a need to fund this excess statutory strain. The auditor can refer to AU section 342, Auditing Accounting Estimates (AICPA, Professional Standards, vol. 1), which provides guidance on obtaining and evaluating sufficient appropriate audit evidence to support significant accounting estimates. In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate and, based on that understanding, should use one or a combination of the approaches included in AU section 342.

- Hedging programs developed by insurers in recent years to manage exposures to policyholder financial options are being reexamined to determine the effect of a decline in a counterparty’s creditworthiness or a company’s own creditworthiness on the fair value of a derivative. The decline in the current market has increased the number of companies experiencing financial problems, resulting in widening credit spreads to bankruptcy. As discussed in FASB Derivatives Implementation Group Statement 133 Implementation Issue No. G10, Cash Flow Hedges: Need to Consider Possibility of Default by the Counterparty to the Hedging Derivative, “The entity must be aware of the counterparty’s creditworthiness (and changes therein) in determining the fair value of the derivative. Although a change in the counterparty’s creditworthiness would not necessarily indicate that the counterparty would default on its obligations, such a change would warrant further evaluation. If the likelihood that the counterparty will not default ceases to be probable, an entity would be unable to conclude that the hedging relationship in a cash flow hedge is expected to be highly effective in achieving offsetting cash flows.” The auditor also can refer to AU section 332, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities (AICPA, Professional Standards, vol. 1), which provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities, and investments in securities.

Guarantees and Other Developments

.17 Variable annuity products that contain minimum guaranteed death benefits (MGDBs) or guaranteed minimum income benefits (GMIBs) pose additional considerations, which include the following:

- Companies may experience general account charges for the payout of these benefits (upon either death or annuitization, as applicable) when the market value of the separate account assets is not sufficient to support the level of benefit payment.

- Generally accepted accounting principles (GAAP) and statutory accounting principles (SAP) may require insurers to establish reserves for variable annuity guarantees on these products, thereby placing strain on capital strength.

.18 The National Association of Insurance Commissioners (NAIC) Risk Based Capital C3 Phase II initiative requires cash-flow testing for annuities or other products with exposure to interest-rate risks. Interest-rate risk may increase if there is a duration mismatch between assets and liabilities. Testing includes multiple scenarios with various interest rate fluctuations to determine whether reserves are adequate. This testing may cause some life insurers to increase their capital requirements for interest-sensitive products.

.19 Companies that issue universal life insurance with no-lapse guarantee mortality features are subject to the provisions of Statement of Position (SOP) 03-1, Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts (AICPA, Technical Practice Aids, ACC sec. 10,870), and should establish liabilities in addition to account balances if amounts assessed each period for the feature are expected to result in profits in earlier years followed by losses in subsequent years.

.20 SOP 03-1 contains guidance for accounting for MGDBs, GMIBs, and no-lapse guarantee features. These features also are addressed in FSP FAS 97-1, Situations in Which Paragraphs 17(b) and 20 of FASB...
Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, Permit or Require Accrual of an Unearned Revenue Liability, and in Technical Practice Aid (TPA) Technical Questions and Answers (TIS) section 6300.08, “Definition of an Insurance Benefit Feature” (AICPA, Technical Practice Aids). Management should be familiar with all of these pronouncements in applying the guidance in SOP 03-1. Auditors also should gain an understanding of these pronouncements, depending on the circumstances of their clients.

Property and Casualty Insurance Industry

.21 The U.S. property and casualty (P&C) insurance industry experienced weak performance in the first half of 2008. Net written premiums declined 0.7 percent continuing the negative growth trend that began in 2007 with a –0.6 percent growth rate. These decreases are significant given that premium growth has not been negative since 1943, in the midst of World War II. During the first six months of 2008, the industry’s net income decreased more than 50 percent to $15.9 billion, whereas the annualized after-tax return on surplus declined to 9.5 percent, down from 14.2 percent return for the 12 months ended June 30, 2007. The first half of 2008 combined ratio was 102.1, which is the highest level it has reached in 6 years.

.22 The industry decline was driven primarily by the housing and credit crisis faced by mortgage insurers and financial guarantee insurers, the continuation of soft market conditions through much of the industry, an increase in catastrophe losses, and a volatile investment market. Each of these performance factors are subsequently discussed in more detail.

Impact of the Housing and Credit Crisis on Mortgage and Financial Guarantee Insurers

.23 Since 2007, securities backed by subprime mortgages have gone into default at record rates due to the slump in the housing market and loans that were extended to borrowers with poor credit histories. Mortgage insurers now face substantial borrower defaults on loans that were approved when the process of securing a mortgage was less difficult. During the first half of 2008, many mortgage and financial guarantee insurers reported significant underwriting losses. According to A.M. Best Research 2008 Special Report, U.S. Property/Casualty—6-Month Financial Review, as of September 23, 2008, although these lines only account for a small percentage of the industry’s net premiums written, their loss impact caused a 5.0 point deterioration on the industry-wide combined ratio. As a result, major rating agencies have downgraded the financial strength ratings of several mortgage insurance companies. Additionally, stock prices for these insurers are decreasing. In reaction, mortgage insurers have tightened their standards, making such insurance more challenging to obtain.

Continuation of the Soft Market Conditions

.24 For the fourth consecutive year, the P&C market remains soft as a consequence of a sustained, highly aggressive pricing environment. This is a result of competitive pressure in practically all lines of property casualty business and geographic areas. Renewals reportedly have declined and pricing increases have lagged the inflation rate. Due to increased competition, advertisement spending by P&C insurers is at a record high, even after accounting for growth premiums.

Surge of Catastrophe Losses

.25 The Insurance Services Office has noted that 2008 first quarter catastrophe losses have reached the highest level of any first quarter since 1994. The second quarter losses doubled the first quarter, allowing

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2 According to the Mortgage Insurance Companies of America 2007–2008 Fact Book & Membership Directory, property and casualty (P&C) insurers that protect lenders against loss from a mortgagor’s default on conventional first home mortgages made to home buyers who make down payments of less than 20 percent of the purchase price.

3 P&C insurers that issue financial guarantees, including the guaranteeing of interest and principal payments on corporate and municipal debt, the guaranteeing of limited partnership obligations, and a number of other products in which the insurance company takes on an obligation to pay at some later date. (AICPA Audit and Accounting Guide Property and Liability Insurance Companies)

4 Subprime mortgages are mortgages used by borrowers with low credit ratings, who are considered risky by lending agencies because the default risk is greater than that of other borrowers. Due to this, lenders charge a higher interest rate on subprime loans.
the total for the first half of 2008 to be greater than the total amount for all of 2007. According to A.M. Best Research, insured catastrophe losses reached $10.3 billion in the first 6 months of 2008, contributing 4.7 percentage points to the industry’s combined ratio. These losses in the first half of the year were due to record-breaking tornado activity, brutal hail, wildfires, and wind damage. Severe flooding in the Midwest also has been a major cause of concern during the second quarter of 2008, costing private insurers $600 million. As of mid-September, 10 storms had been named, including Hurricanes Gustav and Ike. The estimated losses for Gustav range between $2 billion and $10 billion, and estimates for Hurricane Ike are as high as $18 billion. The hurricane season is expected to add earnings pressure to the market, but the overall financial impact is expected to be manageable due to the capital strength of the P&C industry.

Volatile Investment Market

.26 The P&C industry’s profitability has been further adversely affected by volatile investment markets. Stock prices have declined, credit spreads have widened on fixed income securities, and the Federal Reserve has consistently cut rates on federal funds. Approximately two-thirds of P&C investments are in bonds, which are sensitive to interest rates. Recently, the market for investments has been affected by unfavorable news headlines about credit markets, increasing oil prices, and economic weakness. A.M. Best Research notes in the first half of 2008, the industry’s total investment gain slipped by 11.2 percent or $3.4 billion. Investment returns have been significantly affected by the historically low interest rate environment, held constant at 2 percent, according to A.M. Best Research. Further declines are expected through the remainder of 2008 due to the tumultuous financial markets, which will test the strength of a number of insurers.

.27 According to A.M. Best Research 2008 Special Report, U.S. Property/Casualty—1st Quarter Financial Review, as of June 30, 2008, the property liability insurance industry faces a challenging environment for the remainder of 2008, due to a combination of deteriorating rate adequacy, loosening terms and conditions, a difficult investment climate, and catastrophe-related losses. A.M. Best Research notes it appears that the P&C industry will face underwriting losses for the year-end 2008, but believes the industry to be on track for an operating profit. For the long term, Conning Research & Consulting projects a soft market through 2010 with better performance in 2009 and 2010 compared to 2008. They anticipate a rebound in the economy and a moderating competitive environment.

Legislative and Regulatory Developments

Recent Statutory Accounting Principles

.28 The NAIC continues to create and clarify statutory accounting guidance for insurance enterprises through its ongoing maintenance process. The most recent Accounting Practices and Procedures Manual (manual) was published by the NAIC as of March 2008 and contains accounting practices and procedures adopted by the NAIC through December 2007. For manual subscribers, modifications made subsequent to the publication of the manual are available on the NAIC Web site at www.naic.org. Insurance laws and regulations of the state insurance departments require insurance companies domiciled in those states to comply with the guidance provided in the manual, except as otherwise prescribed or permitted by state law or regulation.

.29 The 2008 manual contains one new Statement of Statutory Accounting Principle (SSAP) that was adopted during 2007—SSAP No. 97, Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88. SSAP No. 97 was adopted in December 2007 and was effective for reporting periods ending on or after December 31, 2007.

.30 Most of the revisions incorporated in SSAP No. 97 are related to satisfying the audit requirements applicable in various subsidiary, controlled, and affiliated entities (SCA) situations. The significant changes in SSAP No. 97 include the following:

- Combined audited financial statements are allowed in complying with requirements under SSAP No. 97 that SCA be audited.
• Foreign (non-U.S.) entities are allowed to provide audited financial statements on a foreign basis of accounting, with an audited footnote reconciliation to U.S. GAAP, in complying with the audit requirement under SSAP No. 97.

• In certain circumstances, the “look-through” approach, which permits a company to admit the value of a downstream holding company, is allowed.

.31 Language was added to clarify that the value of preferred stock and surplus notes issued by an SCA are to be deducted from the SCA’s total equity in determining the carrying value attributed to the common stock of such an SCA.

.32 In fall 2008, the following two new SSAPs were issued:

1. SSAP No. 98, Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, An Amendment to SSAP No. 43—Loan-Backed and Structured Securities, requires fair value of the security be used to measure other-than-temporary impairments. In addition, SSAP No. 98 clarifies interest-related declines in value are considered other-than-temporary when there is intent to sell the investment prior to recovery of the cost and also clarifies the asset valuation reserve and interest maintenance reserve treatment of other-than-temporary impairments. This SSAP is effective for quarterly and annual reporting periods beginning on or after January 1, 2009, with early adoption permitted and encouraged.

2. SSAP No. 99, Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment, adopts the guidance in paragraph 16 of FSP FAS 115-1/FAS 124-1 and provides guidance to account for the amortization or accretion of debt securities after an other-than-temporary impairment. Upon impairment of a security, an immediate amortization of premium shall be reported as a realized loss and shall not be included in investment income. This SSAP is effective January 1, 2009, with early adoption permitted.

.33 Additionally, nine new interpretations were adopted during 2007 and incorporated into the March 2008 manual. Also, several nonsubstantive revisions to various SSAPs and manual appendixes were made during 2007 by the NAIC. Interpretations are immediately effective upon adoption by the NAIC, and new SSAP’s occasionally are effective for the calendar year they are adopted. Interim updates to the manual can be found under the SAP Working Group section of the NAIC Web site at www.naic.org/committees_e_app_sapwg.htm. Beginning in 2008, the user identification and password necessary to access adopted updates to the March 2008 manual require the prepurchase of the subsequent year’s manual (the March 2009 publication, in this case).

The NAIC’s Sarbanes-Oxley Initiative Update

.34 The NAIC adopted changes to the Annual Financial Reporting Model Regulation (Model Audit Rule) related to the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) during its fall 2006 meeting, with the majority of the changes effective for 2010.

.35 Highlights of the significant changes made to the Model Audit Rule related to Sarbanes-Oxley include:

• Section 7: The time allowed to serve in the capacity as the lead or coordinating audit partner was decreased from seven years to five consecutive years with a new five year break in service (previously two years), effective beginning with year 2010 statutory audits.

• Section 7: A list of nonaudit services that cannot be performed by the auditor in conjunction with the audit (the prohibitions generally agree with those designated by the Securities and Exchange Commission [SEC]), effective for the year 2010 statutory audits.

• Section 9: To the extent required by AU section 319, Consideration of Internal Control in a Financial Statement Audit (AICPA, PCAOB Standards and Related Rules, PCAOB Standards, As Amended), for those insurers required to file a management’s report on internal control over financial reporting
pursuant to Section 16 (see the following “Section 16” bullet point), the independent CPA should consider the most recently available report in planning and performing the audit of statutory financial statements.

• Section 11: Auditors should prepare a written communication of any unremediated material weaknesses that the insurer will furnish the domiciliary commissioner, effective beginning with year 2010 statutory audits. The current Model Audit Rule requires the auditor to prepare a report of significant deficiencies and material weaknesses in the insurer’s internal control structure noted by the auditor during the audit. The AICPA NAIC Task Force has, for several years, undertaken efforts to confirm that states will accept the reporting of only those significant deficiencies and material weaknesses that are unremediated as of the balance sheet date, and it will continue to do so until the year 2010 effective date of the revised Model Audit Rule.

Until the revisions of this section become effective in 2010, representatives of the AICPA plan on obtaining negative clearance from regulators that they will continue to follow the guidance contained in a March 9, 2005 letter that was sent to regulators. This letter contained suggested guidance for complying with Section 11 of the Model Audit Rule because the term significant deficiencies had a different definition under Sarbanes-Oxley than it had under Section 11 of the Model Audit Rule.

• Section 14: New specifications for the responsibilities of audit committees and the required qualifications of audit committee members will be effective January 1, 2010. The adopted revisions require that insurance companies have an audit committee that is solely responsible for the appointment, compensation, and oversight of the company’s auditor. The guidance also indicates that some audit committees, based on the insurer’s premium volume, would need to be comprised of a certain percentage of individuals who are independent from company management. The premium threshold that triggers the requirement for independent audit committee members is $300 million assumed and direct premiums. The premium range for a majority (50 percent or more) of independent audit committee members is from $300 million to $500 million. The requirement for a supermajority (75 percent or more) of independent audit committee members is $500 million in premiums. Notwithstanding premium volume, all insurers are encouraged to structure their audit committees with at least a supermajority of independent audit committee members.

• Section 16: Every insurer required to file an audited financial report that has an annual direct written and assumed premium of $500 million or more shall prepare a report of the insurers’ or group of insurers’ internal control over financial reporting and file it with their insurance commissioner, effective December 31, 2010. The Model Audit Rule also includes a list of what should be included in management’s report on internal control over financial reporting. This report is prepared by management and is not audited.

An insurer that is a Sarbanes-Oxley compliant entity or is a direct or indirect wholly owned subsidiary of a Sarbanes-Oxley compliant entity will be able to file its or its parent’s Sarbanes-Oxley Act Section 404 report in satisfaction of this Section 16 requirement. However, there also is an addendum that needs to be filed with the Sarbanes-Oxley Act Section 404 report that would include a positive statement that there are no material processes related to the preparation of the audited statutory financial statements that were excluded from the Sarbanes-Oxley Act Section 404 report. If there are internal controls that have a material impact on the preparation of the audited statutory financial statements excluded from the Sarbanes-Oxley Act Section 404 report they need to be addressed. The insurer may either file a report under Section 16 or the insurer can file its Sarbanes-Oxley Act Section 404 report and a Section 16 report for those internal controls that would have a material impact on the audited statutory financial statements and were not covered by the Sarbanes-Oxley Act Section 404 report.

The independent CPA should consider this report during the planning and performance of the annual audit. In addition, the proposed revisions require the insurer to file with the state insurance department the independent public accountant’s communication regarding any unremediated material weaknesses noted during the course of the audit.
SSAP No. 9 Considerations

.36 SSAP No. 9, Subsequent Events, which was based on AU section 560, Subsequent Events (AICPA, Professional Standards, vol. 1), defines subsequent events and establishes criteria for recording such events in the financial statements or disclosing them in the notes to the financial statements. All information that becomes available prior to the issuance of the financial statements relating to a material type I subsequent event (currently defined in SSAP No. 9 as “events that provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements”) shall be used by management in determining the related accounting estimate.

.37 During 2007, the NAIC SAP Working Group adopted revisions to paragraph 13 of SSAP No. 55, Unpaid Claims, Losses and Loss Adjustment Expenses, to address the issue of whether accounting judgments and estimates inherent in the preparation of statutory-basis financial statements should be updated to reflect type I subsequent events occurring between the annual statement filing date and the issuance of the audited statutory-basis financial statements. This amended paragraph clarifies that liabilities for unpaid claims, losses, and loss adjustment expenses within the scope of SSAP No. 55 are not expected to be reestimated. Rather, additional information that is obtained after the submission of the annual statement, which is not indicative of an error in the estimation process, is considered part of the continuous review process and should be reflected in the statement of operations in the period the change becomes known.

.38 Readers should be aware that this guidance applies only to unpaid claims, losses, and loss adjustment expenses within the scope of SSAP No. 55, and that to be compliant with SSAP No. 9 as currently written, companies will need to have a process in place to update other judgments and estimates for type I subsequent events occurring between the annual statement filing date and the issuance of the audited statutory-basis financial statements.

Risk-Focused Statutory Examinations

.39 Companies are examined for statutory purposes by the domestic insurance departments. State regulators perform their financial examinations using the NAIC Financial Condition Examiners Handbook. Beginning in 2010, state examiners will be required to conduct their examinations using a risk-focused approach (although many states have already begun conducting examinations using a risk-focused approach). This examination approach, which is a key component of establishing and operating an effective risk-focused surveillance process, involves several differences from the traditional, more substantive-based statutory examination process. In particular, under the risk-focused approach, there is a heavy emphasis on the insurer’s corporate governance and established risk management practices and processes. At the beginning of the examination, regulators gain an understanding of the corporate governance structure and assess the “tone at the top.” In addition, examiners obtain information on the quality of oversight provided by a company’s board of directors. Examiners also evaluate and assess the effectiveness of senior management as part of this corporate governance assessment process. All of this information contributes to an understanding of how a company identifies, controls, monitors, mitigates, evaluates, and responds to its risks. This assessment helps determine the most significant current and prospective risk areas and assists with determining the amount of substantive examination procedures that state examiners should perform. The examiner’s review and consideration of prospective business risk is designed to focus on key risks to future solvency and allows the regulators to tailor their supervision plan to address key risks.

.40 In conjunction with the previously explained objectives, examiners typically will make inquiries of a company’s external auditor regarding various areas in order to determine potential leverage of the auditor’s work papers. In addition to reviewing areas associated with the auditor’s balance sheet and income statement account testing, the examiners also may be interested in reviewing the auditor’s internal control assessment and testing of the insurer’s corporate governance environment, recognizing that the extent of documentation pertaining to the insurer’s corporate governance structure and risk mitigation strategies will vary based on the size and structure of the company and its holding company group. As part of this assessment, the examiners also may request to see the auditor’s assessment and testing over various
entity-level controls, especially any testing or assessments performed related to the insurer’s enterprise risk management (ERM) structure. Several rating agencies such as A.M. Best Research and Standard & Poor’s have emphasized a review of a company’s ERM environment and practices. If the external auditor has reviewed the ERM practices and potential relationship to the Committee of Sponsoring Organizations of the Treadway Commission ERM framework, the examiner generally will want to review this documentation.

.41 Additionally, once the examiners determine the most significant financial reporting areas of focus, they may be interested in reviewing the external auditor’s testing of certain key internal controls related to public companies’ compliance with Sarbanes-Oxley Act Section 404. The risk and control matrices that outline the risk, key controls, financial statement assertions, testing performed, results of testing, and conclusions reached regarding design and operating effectiveness may be of particular interest to the examiners. The regulators will want to understand the scope of testing by the external auditors and may want to review or reperform certain aspects of the external auditor’s testing in order to establish a basis for reliance. Most companies will want their external auditors to cooperate with the state insurance regulators in order to avoid duplication of effort relating to testing key financial controls.

.42 Furthermore, the regulators may be particularly interested in the scope of information systems testing performed by both the external auditor and the company. Given that data integrity is usually classified as a high inherent risk, the scope of information technology testing performed by the external auditor likely will be of interest to most examiners (that is, testing performed over information technology key controls related to both general and application controls). Smaller companies, as well as Sarbanes-Oxley compliant entities, will be expected to proactively address information technology risks, and the external auditor’s work in this area will be considered important by most examiners.

Federal Initiatives—Treasury Department’s Blueprint for a Modernized Financial Regulatory Structure, an Optional Federal Charter, and an Office of Insurance Information

.43 In March 2008, the Treasury Department released its Blueprint for a Modernized Financial Regulatory Structure (the blueprint). The purpose of the blueprint is to present a series of recommendations to Congress for the reform of the U.S. financial regulatory structure. The blueprint is a key part of the Treasury Department’s efforts to improve the competitiveness of the U.S. capital markets in a global marketplace. One area of proposed reform affects the insurance industry and how the insurance industry is currently regulated by a state-based regulatory system. The blueprint recommends the following:

- The establishment of a federal insurance regulatory structure to provide for the creation of an optional federal charter (OFC). This structure is similar to the current dual-chartering system for banking. An office of national insurance within the Treasury Department would oversee this federal regulatory structure.
- As an intermediate step, Congress would establish a federal office of insurance oversight within the Treasury Department in order to establish a federal presence in insurance for international and regulatory issues with a goal toward providing “more effective, efficient, and consistent regulation for national insurers and [to] enhance product choice and innovation.”

.44 Subsequent to the release of the blueprint, much debate has ensued regarding the merits of moving to a dual regulatory system for insurers. As of this writing, the OFC, if one were to be approved by Congress, is not expected to apply to health insurance. As currently drafted, it will apply to both property-casualty and life insurance lines of business but could ultimately apply only to life insurance. Indications from Treasury officials are that it would be broadly consistent with banking regulation, specifically dealing with charter, licensing, regulation, and supervision for insurers and producers. The state-based system would continue for those deciding not to operate at the national level. Legislation has been introduced in both the U.S. House of Representatives and the U.S. Senate supporting the establishment of an OFC.

.45 The office of insurance oversight that was recommended in the blueprint is now being referred to as the office of insurance information (OII). Legislation to create the OII, the Insurance Information Act of 2008,
was approved in July 2008 by the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Entities. The initial focus of the OII is expected to be on global issues, particularly those pertaining to the European Union’s new framework for insurance regulation; it also is expected to have limited authorities. Auditors should be aware of and monitor developments in the preceding areas and assess effects to disclosures, liability accruals, and subsequent events for 2008 fiscal year-ends.

**National Flood Insurance Program**

The National Flood Insurance Act of 1968 created the National Flood Insurance Program (NFIP) because flood insurance was unavailable from the private insurance markets. The NFIP was overwhelmed by claims from the 2004 and 2005 hurricane season and Congress was forced to raise the program’s borrowing authority to pay claims. It became apparent the NFIP was in need of reform in order to remain viable and provide consumers the desired protection. Additionally, due to consumer’s difficulty in obtaining windstorm coverage in the marketplace and controversial decisions regarding coverage of claims from Hurricanes Rita and Katrina, there has been a move to have the NFIP offer both windstorm and flood coverage. A U.S. House of Representatives bill passed in 2007 to reform the program and offer windstorm coverage. In July 2008, the U.S. Senate Committee on Banking, Housing, and Urban Affairs voted on its own legislative version to reform the NFIP; however, it did not propose an expansion of the program to the offering of windstorm coverage. The U.S. Senate voted to extend the NFIP through September 30, 2013. The Office of Management and Budget said that it would recommend the president veto any extension bill that contained the windstorm provision. U.S. House of Representatives and U.S. Senate negotiators will have to iron out differences between the two bills so the NFIP can be extended beyond its September 30, 2008 expiration. Auditors should be aware of and monitor developments in this area and assess effects to disclosures, liability accruals, and subsequent events for 2008 fiscal year-ends.

**Terrorism Insurance Developments**

The market for terrorism risk insurance was severely disrupted by the events of September 11, 2001. Those events resulted in reinsurers no longer covering terrorism risk or offering coverage only at very high rates. On November 26, 2002, the president signed the Terrorism Risk Insurance Act (TRIA) into law. The TRIA established a temporary federal program of shared public and private compensation for insured commercial P&C losses resulting from acts of terrorism.

Accordingly, terrorism exclusions on existing insurance policies were removed, and all policyholders had the ability to secure coverage for terrorism risk through mandatory offer requirements placed on insurers. The TRIA, as amended in 2005, placed the federal government temporarily in the terrorism risk reinsurance business because the program was written to expire on December 31, 2007. With expiration imminent, the TRIA was amended on December 26, 2007 by the Terrorism Risk Insurance Program Reauthorization Act of 2007 (the Reauthorization Act), which extended the TRIA for another seven years, or through December 31, 2014. A summary of the 2007 amendments, which are in effect for 2008, are discussed in the following paragraphs of this alert.

Under the original program, once an insurer suffers a loss equal to its deductible, the Treasury Department covers 90 percent of the losses above the deductible. The insurer’s deductible increases over the life of the program. The TRIA also provides the Treasury Department with the authority to recoup federal payments via policyholder surcharges. The maximum amount of any potential policyholder surcharge that can be imposed is 3 percent per year.

A summary of the major changes as a result of the 2007 amendments is as follows:

- The definition of act of terrorism was revised to remove the requirement that the act of terrorism be committed by an individual acting on behalf of any foreign person or foreign interest in order to be certified as an act of terrorism for purposes of the TRIA. Insurers have designed their insurance
contracts and notifications to policyholders differently concerning potential changes to the certification criteria for acts of terrorism. Insurers must determine how their policy language and particular circumstances are affected by the revised definition of an act of terrorism.

- The definition of insurer deductible was revised for all additional program years as the value of an insurer’s direct earned premium for commercial P&C insurance for the immediately preceding calendar year multiplied by 20 percent.
- The federal share of compensation for insured losses (subject to a $100 million program trigger) for all additional program years is set at 85 percent of that portion of the amount of insured losses that exceeds the applicable insurer deductible.
- The Treasury Department is required to submit a report to Congress and issue final regulations for determining the pro rata share of insured losses to be paid under the program when aggregate insured losses exceed the annual liability cap of $100 billion.
- The Secretary of the Treasury is required to notify Congress not later than 15 days after the date of an act of terrorism about whether aggregate insured losses are estimated to exceed $100 billion.
- For policies issued after the date of enactment, insurers are required to provide clear and conspicuous disclosure to the policyholder of the existence of the $100 billion cap at the time of offer, purchase, and renewal of a policy (in addition to current disclosure requirements).
- The recoupment provisions of the TRIA have been revised. For purposes of recouping the federal share of compensation under the TRIA, the insurance marketplace aggregate retention amount for all additional program years is the lesser of $27.5 billion and the aggregate amount, for all insurers, of insured losses during each program year. With regard to mandatory recoupment of the federal share of compensation through policyholder surcharges, collection is required within a certain schedule specified in the Reauthorization Act. The limitation that surcharges not exceed 3 percent of the premium charged for P&C insurance coverage under the policy is eliminated (but remains in the case of discretionary recoupment).

.51 Auditors should remain alert to developments in this area and assess effects to disclosures, liability accruals, and subsequent events for 2008 fiscal year-ends. The concern with the expiration of the TRIA in 2014 is that, in the absence of a federal program, it is likely that terrorism exclusions will become the norm for commercial line policies, and private reinsurers are not likely to fill the reinsurance capacity void.

.52 The NAIC has adopted a model bulletin to provide guidance to insurers related to rate filings and policy language that state regulators would find acceptable to protect U.S. businesses from acts of terrorism. They also have developed Model Disclosure Forms 1 and 2 to assist insurers in complying with the TRIA. The model disclosure forms may be used and modified by insurers to meet their obligation under the rules, provide policyholders with the status of current coverage, and, in some cases, make a selection regarding future insurance coverage for acts of terrorism. Insurers must comply with state law and the TRIA and are encouraged to review the disclosure forms in light of their current policy language, state legal requirements, and the provisions of the TRIA amendments and the Terrorism Risk Insurance Program.

Audit and Attestation Issues and Developments

Audit Risks Arising From Current Economic Conditions

.53 As mentioned in “The State of the Economy,” unprecedented events occurred in the financial markets in September 2008 resulting in Congress appropriating up to $700 billion to purchase various asset-backed securities. Generally, many fixed income markets became extraordinarily illiquid in late September 2008, resulting in a substantial increase in risk over the valuation assertion for virtually any kind of fixed income security of any duration. Also, concerns existed about the possibility of significant redemptions from various types of funds and some reports of certain private funds either placing limits on redemptions, freezing the ability to redeem entirely, or determining to commence an orderly wind-down of operations. Thus,
subsequent events reporting considerations, and assessment of the “going concern” status of some entities, take on added importance in the current environment as well.

.54 The AICPA staff has issued TIS section 1100.15, “Liquidity Restrictions” (AICPA, Technical Practice Aids), addressing the potential accounting and auditing implications when a fund or its trustee imposes restrictions on a nongovernmental entity’s ability to withdraw its balance in a money market fund or other short term investment vehicle. The question and answer covers balance sheet classification, disclosures, debt covenants, subsequent events, and going concern considerations, among other things, and can be found at www.aicpa.org/download/acctstd/TIS1100_15.pdf.

.55 Recent economic conditions may cause additional risk factors that had not existed or did not have a material effect on audit clients in prior years. When obtaining an understanding of the external factors that affect the entity and the risks associated with those factors, the auditor may consider whether conditions exist that indicate risks of material misstatement. Some examples that relate to economic conditions are as follows:

- Operations that are exposed to volatile markets, which may include oil, agriculture, or currency markets
- Constraints on the availability of capital and credit
- Operations in regions with economic volatility, including employment and housing issues
- Going concern and liquidity issues

.56 In addition to economic conditions, external forces such as natural disasters significantly affect the insurance industry, especially property and liability insurance. Although many of these risks are not new to business, consideration of the many ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks.

Other-Than-Temporary Impairments

.57 Emphasis has increased on accounting for and proper disclosure of other-than-temporary impairments of debt and equity investments due to the continued negative decline in the market. Auditors should refer to FSP FAS 115-1/FAS 124-1 and EITF Issue No. 99-20 for assistance in evaluating a company’s assessment of whether an impaired investment is other-than-temporarily impaired.

Liquidity

.58 Also, due to the significant upheaval in the current market, auditors should pay particular attention to the company’s liquidity and capital resources, and whether the current conditions could affect the company’s ability to continue as a going concern. AU section 341, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern (AICPA, Professional Standards, vol. 1), requires auditors to evaluate whether there is substantial doubt about an entity’s ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. Statement on Auditing Standards No. 114, The Auditor’s Communication With Those Charged With Governance (AICPA, Professional Standards, vol. 1, AU sec. 380), requires that auditors communicate with those charged with governance events or conditions that lead the auditor to believe there is substantial doubt about the entity’s ability to continue as a going concern.

Valuation

.59 It has become difficult to obtain input for determining the fair value of auction rate securities, money market funds, commercial paper, mortgage-backed or other asset-backed securities, collateralized debt obligations, and municipal securities due to the slowdown in trading caused by the current market. Auditors
should refer to FSP FAS 157-3 for help in clarifying the application of FASB Statement No. 157 in a market that is not active.

Reinsurance

.60 Auditors of companies with significant reinsurance contracts may want to request that management state in its representation letter to the auditor that there are no side agreements to reinsurance contracts, or, alternatively, that the auditor has been informed of any such agreements in order to enable a determination about whether the company has properly considered these agreements in the accounting analysis for the contract. Auditors of companies with significant reinsurance contracts also may consider directing procedures under AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), toward these arrangements to identify any of the following:

- Contracts backdated to avoid retroactive reinsurance accounting on coverage of losses that had already been incurred
- Side agreements to reimburse the reinsurer for covered losses or to return profits under a contract in a different accounting period, which may compel accounting accruals
- Linked contracts where losses experienced under one will be reimbursed under another in the future and which should be considered together in the risk transfer analysis
- Contracts whose terms do not make economic sense and indicate a side agreement, or linkage, with another contract that should be considered in the accounting evaluation
- Exclusive reinsurance arrangements with offshore assuming companies that raise consolidation questions
- Commutations where the settlements are not in accordance with contract terms and suggest a noncontractual agreement on the allocation of profits and losses
- Contracts where the risk transfer analysis supporting the accounting evaluation differs materially from and cannot be reconciled to cash flow analyses included in the underwriting file

Reinsurance Recoverables

.61 Consideration should be given to the terms of the reinsurance agreements and the creditworthiness of the reinsurer. Significant payment terms may be material to liquidity and required capital levels. As previously noted, auditors should refer to AU section 341. Due to continued downturns in the market, the auditor should give significant consideration to whether the company complies with regulatory risk-based capital requirements when evaluating an insurance company’s ability to continue as a going concern.

Claims Expense and Loss Reserves

.62 Due to the increased number and complexity of transactions surrounding claims and claim expenses, inherent risk surrounding the recording and payout of claims can increase. Auditors should evaluate their client’s response and adherence to criteria and related controls surrounding expenses.

.63 The identification of changes surrounding valuation variables and consideration of their effect on losses are critical audit steps. The evaluation of these factors includes the involvement of specialists and input from various operating departments within the company, such as marketing, underwriting, actuarial, reinsurance, and legal. Readers should remember that losses are only accrued for events that have occurred; catastrophe reserves are not allowed in anticipation of future events.

.64 AU section 342 states that the auditor should obtain an understanding of how management developed the accounting estimates included in the financial statements. Claims expense and loss reserve estimates are significant variables on an insurance company’s financial statements. Accordingly, regardless of the approach used to audit claims expense and loss reserve estimates, the auditor should gain an
understanding of how management develops estimates. Additionally, chapter 4 and appendix A of the AICPA Audit and Accounting Guide *Property and Liability Insurance Companies* is an additional source of guidance.

.65 Auditors also can refer to AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), as well as noting current practitioner prohibitions and restrictions that exist related to the performance of nonaudit services for audit clients, including certain actuarial services. Practitioners should be aware of and comply with these prohibitions and restrictions, including the AICPA, SEC, and Public Company Accounting Oversight Board (PCAOB) independence rules; new NAIC rules describing qualifications of an independent CPA included in the Model Audit Rule effective for 2010 statutory audits; and rules passed by the U.S. Government Accountability Office, state licensing boards, and others.

**Summary of Recent Auditing and Attestation Pronouncements and Related Guidance**

.66 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. This alert is intended to be used in conjunction with the *Comprehensive Audit Risk Alert—2008* (product no. 022339kk); therefore, only industry specific pronouncements and related guidance or those of specific significance to the industry are summarized herein. For information on auditing and attestation standards issued subsequent to the writing of this alert, please refer to the AICPA Accounting and Auditing Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing. You also may look for announcements of newly issued standards in the CPA Letter, *Journal of Accountancy*, and in the quarterly electronic newsletter *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

.67 The PCAOB establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review Audit Risk Alert *SEC and PCAOB Developments—2008* (product no. 022499kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by visiting www.cpa2biz.com.

<table>
<thead>
<tr>
<th>Recent Auditing and Attestation Pronouncements and Related Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue Date: October 2008</td>
</tr>
<tr>
<td>(Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])</td>
</tr>
<tr>
<td>Replacing SAS No. 112, <em>Communicating Internal Control Related Matters Identified in an Audit</em>, this standard defines the terms <strong>deficiency in internal control</strong>, <strong>significant deficiency</strong>, and <strong>material weakness</strong>; provides guidance on evaluating the severity of deficiencies in internal control identified in an audit of financial statements; and requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit. It is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.</td>
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<tr>
<td>Recent Auditing and Attestation Pronouncements and Related Guidance</td>
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<tr>
<td><strong>SAS No. 114, The Auditor’s Communication With Those Charged With Governance</strong> (AICPA, Professional Standards, vol. 1, AU sec. 380)</td>
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<tr>
<td><strong>Issue Date: December 2006</strong></td>
</tr>
<tr>
<td><strong>SAS No. 113, Omnibus Statement on Auditing Standards—2006</strong> (AICPA, Professional Standards, vol. 1)</td>
</tr>
<tr>
<td><strong>Issue Date: November 2006</strong></td>
</tr>
<tr>
<td>(Applicable to audits conducted in accordance with GAAS)</td>
</tr>
<tr>
<td><strong>SAS Nos. 104–111, the risk assessment standards</strong></td>
</tr>
<tr>
<td><strong>Issue Date: March 2006</strong></td>
</tr>
<tr>
<td>(Applicable to audits conducted in accordance with GAAS)</td>
</tr>
<tr>
<td><strong>Issue Date: October 2008</strong></td>
</tr>
</tbody>
</table>

(continued)
<table>
<thead>
<tr>
<th><strong>Recent Auditing and Attestation Pronouncements and Related Guidance</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SSAE No. 14, SSAE Hierarchy</strong> (AICPA, Professional Standards, vol. 1, AT sec. 50)</td>
</tr>
<tr>
<td>Issue Date: November 2006</td>
</tr>
<tr>
<td>Issue Date: March 2002 Revised Date: May 2008</td>
</tr>
<tr>
<td><strong>Interpretation No. 19, “Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board,” of AU section 508</strong> (AICPA, Professional Standards, vol. 1, AU sec. 9508 par. 93–97)</td>
</tr>
<tr>
<td>Issue Date: May 2008</td>
</tr>
<tr>
<td><strong>Interpretation No. 2, “Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board,” of AU section 534, Reporting on Financial Statements Prepared for Use in Other Countries</strong> (AICPA, Professional Standards, vol. 1, AU sec. 9534 par. 05–08)</td>
</tr>
<tr>
<td>Issue Date: May 2008</td>
</tr>
<tr>
<td>Interpretation/Statement/Question</td>
</tr>
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<tr>
<td>Statement of Position (SOP) 07-2, Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisers, or Other Service Providers (AICPA, Technical Practice Aids, AUD sec. 14,430)</td>
</tr>
<tr>
<td>AICPA Technical Questions and Answers (TIS) section 1100.15, “Liquidity Restrictions” (AICPA, Technical Practice Aids)</td>
</tr>
<tr>
<td>TIS section 9120.08, “Part of an Audit Performed in Accordance With International Standards on Auditing” (AICPA, Technical Practice Aids)</td>
</tr>
<tr>
<td>TIS section 9100.06, “The Effect of Obtaining the Management Representation Letter on Dating the Auditor’s Report” (AICPA, Technical Practice Aids)</td>
</tr>
<tr>
<td>TIS section 8350.01, “Current Year Audit Documentation Contained in the Permanent File” (AICPA, Technical Practice Aids)</td>
</tr>
</tbody>
</table>
## Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Source</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, Audit Confirmations (AICPA, Technical Practice Aids, PA sec. 16,240)</strong></td>
<td>This practice alert is a response to practitioners’ current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations, among other topics. Revised: June 2007 (Nonauthoritative)</td>
</tr>
<tr>
<td><strong>AICPA PITF PA 07-1, Dating of the Auditor’s Report and Related Practical Guidance (AICPA, Technical Practice Aids, PA sec. 16,290)</strong></td>
<td>This practice alert provides guidance regarding application of certain provisions of AU section 339, primarily related to dating the auditor’s report. Issue Date: January 2007 (Nonauthoritative)</td>
</tr>
<tr>
<td><strong>Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 6, Evaluating Consistency of Financial Statements (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)</strong></td>
<td>This standard and its related amendments update the auditor’s responsibilities to evaluate and report on the consistency of a company’s financial statements and align the auditor’s responsibilities with Financial Accounting Standards Board (FASB) Statement No. 154, Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3. This standard also improves the auditor reporting requirements by clarifying that the auditor’s report should indicate whether an adjustment to previously issued financial statements results from a change in accounting principles or the correction of a misstatement. Issue Date: November 15, 2008 (Applicable to audits conducted in accordance with PCAOB standards)</td>
</tr>
<tr>
<td><strong>PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)</strong></td>
<td>This standard replaces the PCAOB’s previous internal control standard, Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements. This principles-based auditing standard is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company’s financial statements, and, at the same time, eliminate procedures that are unnecessary. Auditing Standard No. 5 is required to be used by registered audit firms for all audits of internal control over financial reporting no later than for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted and encouraged. Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)</td>
</tr>
</tbody>
</table>
### Recent Auditing and Attestation Pronouncements and Related Guidance

**PCAOB Rule 3526, Communication with Audit Committees Concerning Independence**  
(AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”)  
**Issue Date:** August 2008  
(Applicable to audits conducted in accordance with PCAOB standards)

Rule 3526 requires the registered public accounting firm to:

- describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence.
- discuss with the audit committee of the issuer, the potential effects of any relationships that could affect independence, should they be appointed as the issuer’s auditor.
- document the substance of these discussions. These discussions should occur at least annually.

The board also adjusted the implementation schedule for PCAOB Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles* (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”), as it applies to tax services. The board agreed not to apply Rule 3523 to tax services provided on or before December 31, 2008, when those services are provided during the audit period and are completed before the professional engagement period begins. The amendments to Rule 3523 became effective August 28, 2008. The remaining provisions of Rule 3526 became effective on September 30, 2008.

**PCAOB Rule 3525, Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting**  
(AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”)  
**Issue Date:** July 2007  
(Applicable to audits conducted in accordance with PCAOB standards)

This rule requires a registered public accounting firm that seeks preapproval of an issuer audit client’s audit committee to perform internal control-related nonaudit services that are not otherwise prohibited by the act or the rules of the Securities and Exchange Commission or the PCAOB to describe, in writing, to the audit committee the scope of the proposed service, discuss with the audit committee the potential effects of the proposed service on the firm’s independence, and document the substance of the firm’s discussion with the audit committee. These requirements parallel the auditor’s responsibility in seeking audit committee preapproval to perform tax services for an audit client under PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services* (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”). This rule is effective for audits of fiscal years ending on or after November 15, 2007.

**PCAOB Conforming Amendments to the Interim Auditing Standards**  
(AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)  
**Issue Date:** November 15, 2008  
(Applicable to audits conducted in accordance with PCAOB standards)

In conjunction with the PCAOB’s adoption of Auditing Standard No. 6, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in appendix 2 of PCAOB Release No. 2008-001 at www.pcaob.org/Rules/Docket_023/PCAOB_Release_No._2008-001_-_Evaluating_Consistency.pdf.

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### Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Source</th>
<th>Details</th>
</tr>
</thead>
<tbody>
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<td>In conjunction with the PCAOB’s adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in appendix 3 of PCAOB Release No. 2007-005A at <a href="http://www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf">www pcaob org/ Rules/ Docket_021/2007-06-12_Release_No_2007-005A.pdf</a>. These amendments are effective for audits of fiscal years ending on or after November 15, 2007, the same effective date of Auditing Standard No. 5.</td>
</tr>
<tr>
<td>Issue Date: July 2007</td>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
</tr>
<tr>
<td>PCAOB Release No. 2007-001, Observations on Auditors’ Implementation of PCAOB Standards Relating to Auditors’ Responsibilities With Respect to Fraud (AICPA, PCAOB Standards and Related Rules, “Select SEC-Approved PCAOB Releases”)</td>
<td>This release focuses on aspects of the PCAOB’s interim auditing standards that address the auditor’s responsibility with respect to fraud, specifically AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1). This report does not change or propose to change any existing standard nor is the PCAOB providing any new interpretation of existing standards.</td>
</tr>
<tr>
<td>Issue Date: January 2007</td>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
</tr>
</tbody>
</table>
| PCAOB Staff Questions and Answers, Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 100 par. .05) | Topics covered include the following:  
  - The application of PCAOB Rule 3522(a), Tax Transactions (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”), when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm  
  - Whether a public accounting firm can advise an audit client on the tax consequences of structuring a particular transaction  
  - Whether a registered public accounting firm’s independence is affected by the IRS’s subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in Rule 3522(b)  
  - Clarification that the auditor must evaluate whether a person is in a financial reporting oversight role at affiliates and not just the audit client itself  
  - Clarification of the term other change in employment event as it relates to Rule 3522(c) |
| Issue Date: April 2007                                                | (Applicable to audits conducted in accordance with PCAOB standards)                                                                                                                                                                                                                                                                      |
| PCAOB Staff Audit Practice Alert No. 2, Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 400 par. .02) | This practice alert highlights certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of generally accepted accounting principles that are particularly relevant to the current economic environment. |
| Issue Date: December 2007                                             | (Applicable to audits conducted in accordance with PCAOB standards)                                                                                                                                                                                                                                                                      |
Accounting Issues and Developments

Other-Than-Temporary Impairments

.68 Much attention has been given to the topic of other-than-temporary impairments, particularly due to the continuing declines in the markets. The resulting extended declines in the fair values of many investment securities have brought attention about whether these declines should be considered an other-than-temporary impairment. Significant judgment is involved in determining whether a decline in fair value is temporary or reflects conditions that are more persistent. An investor should assess whether an impaired investment is other-than-temporarily impaired at every reporting period and recognize an impairment loss when the impairment is deemed other-than-temporary even if a decision to sell has not yet been made.

.69 As mentioned earlier in this alert, auditors should refer to FSP FAS 115-1/FAS 124-1, EITF Issue No. 99-20, and FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, depending on the type of investment security, for guidance in determining whether an impaired investment is other-than-temporarily impaired.

.70 Under SAP, determining whether impairment has occurred on an investment under the NAIC Accounting Practices and Procedures Manual is similar to GAAP. Management needs to consider all available evidence in determining whether an impairment exists and if that impairment is other than temporary. SSAP No. 99 adopts the guidance in paragraph 16 of FSP FAS 115-1/124-1 and provides guidance to account for the amortization or accretion of debt securities after an other-than-temporary impairment. Upon impairment of a security, an immediate amortization of premium shall be reported as a realized loss and shall not be included in investment income.

Reinsurance Arrangements

.71 During the past several years, the SEC, the New York attorney general’s office, several state insurance departments, and other governmental and regulatory bodies have been investigating the use of and accounting for finite reinsurance contracts. Several companies have restated previously issued financial statements with respect to accounting for certain reinsurance arrangements and some insurance company executives have been indicted or are the subject of enforcement actions. Reinsurance accounting and reporting—in particular, the question of what constitutes significant transfer of insurance risk and whether side agreements exist between ceding and assuming companies that may have accounting consequences—continue to be important issues requiring careful analysis.

.72 FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts, and EITF Topic No. D-34, “Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113,” continue to be the primary sources of guidance used to determine whether a contract transfers significant insurance risk and meets the conditions for reinsurance accounting. In 2005, FASB undertook a project on insurance risk transfer, the objective of which was to clarify what constitutes transfer of significant insurance risk in insurance and reinsurance contracts. In 2007, FASB discussed editorial changes to FASB Statement No. 113 in order to clarify the risk transfer conditions and enhance required disclosures. Those changes were not issued and FASB removed the insurance risk transfer project from its agenda in June 2008 to better align FASB’s agenda with its Memorandum of Understanding with the International Accounting Standards Board (IASB). FASB plans to consider at a future date whether to address insurance accounting in a joint project with the IASB.

.73 EITF Issue No. 93-6, “Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises”; EITF Issue No. 93-14, “Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises”; and EITF Topic No. D-35, “FASB Staff Views on Issue No. 93-6, ‘Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises’,” represent guidance on required accruals when future rights and obligations under a multiple-year contract change based on loss experience to date.
SOP 98-7, Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk (AICPA, Technical Practice Aids, ACC sec. 10.760), should be used to determine the appropriate method of accounting for contracts that do not meet the requirements for reinsurance accounting under FASB Statement No. 113. SOP 98-7 outlines the appropriate accounting for contracts based on whether the contract transfers the following:

- Only significant timing risk
- Only significant underwriting risk
- Neither significant timing nor underwriting risk
- An indeterminate risk

Other accounting standards continue to have implications for transactions involving reinsurance arrangements. For example, FASB Interpretation No. (FIN) 46 (revised 2003), Consolidation of Variable Interest Entities—an interpretation of ARB No. 51, may necessitate counterparties to reinsurance arrangements placed in certain kinds of structures or entities (for example, catastrophe bond structures) to consider consolidation of these structures or entities. In addition, certain reinsurance contracts may contain embedded derivatives that require accounting in accordance with FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. FASB Derivatives Implementation Group Statement 133 Implementation Issue No. B36, Embedded Derivatives: Modified Coinsurance Arrangements and Debt Instruments That Incorporate Credit Risk Exposures That Are Unrelated or Only Partially Related to the Creditworthiness of the Obligor under Those Instruments, addresses embedded derivatives in modified coinsurance and coinsurance with funds-withheld arrangements and other contracts with similar provisions where, for example, a return under the contract is calculated based on a referenced pool of assets. This implementation issue, which was last updated in June 2006, can be accessed on the FASB Web site at www.fasb.org/derivatives/issuindex.shtml.

As products become more advanced and complex, careful consideration is required to determine whether the contracts are being accounted for appropriately based on a complete understanding of the facts and circumstances. Alternative risk transfer products and finite risk covers usually present complex issues with respect to evaluating the contracts for risk transfer under FASB Statement No. 113 and determining proper accruals under FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises; FASB Statement No. 113; and EITF Issue No. 93-6 (for example, whether premium recognition should be accelerated as reinsurance coverage is exhausted). Auditors should assess whether companies have adequate internal controls to identify and analyze complex reinsurance agreements in order to determine the proper accounting.

Convergence With International Financial Reporting Standards

Since the signing of the Norwalk Agreement by FASB and the IASB, the bodies have had a common goal—one set of accounting standards for international use. In this agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. In 2005 meetings, FASB and the IASB reaffirmed their commitment to the convergence of U.S. GAAP and International Financial Reporting Standards (IFRS). A common set of high quality, globally accepted standards remains the long-term strategic priority of both FASB and the IASB.

FASB and the IASB have undertaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and IFRS. These ongoing joint projects address the conceptual framework, business combinations, financial statement presentation, and revenue recognition. In September 2008, FASB and the IASB published an update of their 2006 Memorandum of Understanding to update the progress they have made since 2006 and to set the goal of completing their major joint projects by 2011. For more information on the status of this project go to www.fasb.org and www.iasb.org.
SEC Eases Acceptance of IFRS Financial Statements

.79 On December 21, 2007, the SEC took a major step toward easing the acceptance of IFRS financial statements by adopting rules to accept from foreign private issuers financial statements prepared in accordance with IFRS as issued by the IASB without reconciliation to U.S. GAAP. This rule marks an important step in the process toward the development of a single set of high quality, globally accepted accounting standards. This rule became effective March 4, 2008. Readers can access this rule at www.sec.gov/rules/final/2007/33-8879.pdf.

.80 More than 100 countries now either require or allow the use of IFRS for the preparation of financial statements by listed companies, and additional countries are moving to do the same. This recent movement to IFRS outside the U.S. has resulted in an increase of filings with the SEC of foreign private issuers that represent in the footnotes to their financial statements that their financial statements comply with IFRS as published by the IASB—from a relative few in 2005 to approximately 110 in 2006. The SEC expects this number will continue to increase in the future, particularly pursuant to Canada’s announced move to IFRS, as there currently are approximately 500 foreign private issuers from Canada.

.81 This movement to IFRS also has begun to affect U.S. issuers, in particular those with a significant global footprint. For instance, certain U.S. issuers may compete for capital globally in industry sectors in which a critical mass of non-U.S. companies report under IFRS. Also, U.S. issuers with subsidiaries located in jurisdictions that have moved to IFRS may prepare those subsidiaries’ financial statements in IFRS for purposes of local regulatory or statutory filings. Readers should remain alert to developments regarding convergence.

IFRS “Roadmap”

.82 On August 27, 2008, the SEC voted to publish for public comment a proposed roadmap that could lead to the use of IFRS by U.S. issuers beginning in 2014. The SEC would make a decision in 2011 on whether adoption of IFRS is in the public interest and would benefit investors. The proposed multiyear plan sets out several milestones that, if achieved, could lead to the use of IFRS by U.S. issuers in their filings with the SEC.

.83 The top 20 companies in each industry, as determined by market capitalization, could elect to begin filing IFRS financial statements for fiscal periods ending after December 15, 2009. If, in 2011, the SEC adopts IFRS for all filers, the roadmap suggests mandatory filing for large accelerated filers beginning in 2014, accelerated filers in 2015, and nonaccelerated filers in 2016. The 90 day comment period ends on February 19, 2009.

.84 The proposed roadmap sets forth seven milestones that will influence the SEC’s decision to adopt IFRS for all filers. These milestones relate to improvements in accounting standards, the accountability and funding of the International Accounting Standards Committee Foundation, the improvement in the ability to use interactive data for IFRS reporting, education and training relating to IFRS, limited early use of IFRS where this would enhance comparability for U.S. investors, the anticipated timing of future rulemaking by the SEC, and the implementation of the mandatory use of IFRS by U.S. issuers.

.85 Additionally, the roadmap discusses two alternatives for U.S. issuers that elect to use IFRS to disclose U.S. GAAP information. Proposal A suggests a U.S. issuer that elects to file IFRS financial statements would provide the reconciling information from U.S. GAAP to IFRS called for under IFRS 1, First-Time Adoption of International Financial Reporting Standards, in a footnote to its audited financial statements. This information would include the restatement of and reconciliation from the prior year’s financial statements and the related disclosures.

.86 Proposal B suggests that U.S. issuers that elect to file IFRS financial statements would provide the reconciling information from U.S. GAAP to IFRS required under IFRS 1, and also would disclose on an annual basis certain unaudited supplemental U.S. GAAP financial information covering a three year period.
This unaudited supplemental financial information would be in the form of a reconciliation from IFRS to U.S. GAAP.

.87 The roadmap does not address how the SEC would mandate IFRS; however, it noted an option would be, “for the FASB to continue to be the designated standard setter for purposes of establishing the financial reporting standards in issuer filings with the Commission. In this option our presumption would be that the FASB would incorporate all provisions under IFRS, and all future changes to IFRS, directly into generally accepted accounting principles as used in the United States. This type of approach has been adopted by a significant number of other jurisdictions when they adopted IFRS as the basis of financial reporting in their capital markets.”


AICPA Launches IFRS.com Web Site

.89 The AICPA is calling for an orderly transition and reasonable time frame of three to five years for the U.S. accounting profession to adopt IFRS. During a FASB forum on June 16, 2008, held to facilitate an open dialogue about whether and how to move the U.S. financial reporting system to IFRS and define the next steps in that process, it was noted that awareness of IFRS is growing, but most believe it will take three to five years to prepare.

.90 To assist in both awareness building and education, the AICPA launched a new Web site, www.ifrs.com, in May 2008. The site provides current information about developments in international convergence. The growing acceptance of IFRS as a basis for U.S. financial reporting represents a fundamental change for the U.S. accounting profession. Acceptance of a single set of high-quality accounting standards for worldwide use by public companies has been gaining momentum around the globe for the past few years.

.91 Developed by the AICPA, in partnership with its marketing and technology subsidiary, cpa2biz, IFRS.com provides a comprehensive set of resources for accounting professionals, auditors, financial managers, audit committees, and other users of financial statements.

.92 The Web site features tools and resources to help CPAs get acquainted with IFRS, the surrounding issues, and available support. Resources include a history of convergence, a high-level overview of the differences between IFRS and U.S. GAAP, frequently asked questions, articles, textbooks, continuing professional education (CPE) courses and live conference training, helpful links, and assistance for audit committee members.

FASB Accounting Standards Codification™

.93 On January 15, 2008, FASB launched the one-year verification period of FASB Accounting Standards Codification™ (ASC). FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing all authoritative literature in a topically organized structure. FASB ASC includes all accounting standards issued by a standard setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, AICPA, EITF, and related literature. FASB ASC also includes relevant authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance.

.94 The purpose of FASB ASC is not to change GAAP, but rather to reorganize thousands of GAAP pronouncements into approximately 90 topics. At the end of the one-year verification period, FASB is expected to formally approve FASB ASC as the single source of authoritative U.S. accounting and reporting standards, other than guidance issued by the SEC. At that time, FASB will supersede all then-existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the codification will become nonauthoritative. FASB expects to approve FASB ASC in April 2009. FASB ASC can be accessed at http://asc.fasb.org/home.
The insurance portion of FASB ASC was released in September 2008. Constituents are encouraged to use FASB's online FASB ASC Research System free of charge and provide feedback to FASB on the codification.

The AICPA has published the Financial Reporting Alert FASB Codification Developments—2008 (product no. 029209kk). This Financial Reporting Alert is intended to provide a better understanding of FASB ASC, outline its structure, as well as provide case studies on navigating the FASB ASC Research System and performing accounting research.

NAIC Reinsurance Disclosure and Filing Requirements

Some reinsurance disclosures that consist of interrogatories directed at disclosing certain finite reinsurance situations were added to SSAP No. 62, Property and Casualty Reinsurance, in 2006, with minor modification in 2007. These reinsurance interrogatory disclosures are required to be included as accompanying supplemental schedules to the annual audited financial statements of P&C insurance companies. These disclosures, which also are included as interrogatories in the annual statement, require detailed information about specific ceded reinsurance contracts. Reinsurance issues took center stage at the NAIC as regulators reacted to the former New York state attorney general's investigations of finite reinsurance, as well as allegations that undisclosed side agreements between ceding and assuming companies contributed to some P&C insolvencies.

The required disclosures include the following:

- Whether any quota share reinsurance contracts include provisions that would limit the reinsurer’s losses below the stated quota share percentage (for example, a deductible, loss ratio corridor, loss cap, aggregate limits, or similar provisions). If such contracts exist, management is required to disclose the number of such contracts and whether the amount of credit taken under such contracts reflects the reduction in quota share coverage caused by any applicable provisions.
- Whether any significant reinsurance contracts contain any of six specific contractual features often associated with finite reinsurance arrangements.
- Whether there are any significant reinsurance contracts with related parties, other than approved pooling arrangements.
- Whether any contracts are accounted for as reinsurance under SAP and as deposits under GAAP, or vice versa, and, if so, why.

For contracts meeting the second and third bulleted criteria, management is further required to disclose a summary of the reinsurance contract terms; a brief discussion of management’s principal objectives in entering into the agreement, including the economic purpose to be achieved; and the aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income.

Summary of Recent Accounting Pronouncements and Related Guidance

Presented in the following table is a list of recently issued accounting pronouncements and related guidance. This alert is intended to be used in conjunction with the Comprehensive Audit Risk Alert—2008 (product no. 022339kk); therefore, only industry specific pronouncements and related guidance or those of specific significance to the industry are summarized herein. For information on accounting standards issued subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org and the FASB.

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5 Significant is defined as those contracts having an underwriting gain or loss or either ceded written premiums or ceded loss and loss expense reserves greater than 5 percent of the prior year-end surplus as regards policyholders.

6 The six specific contractual features are (1) a contact term greater than two years when the contract is noncancelable by the reporting entity, (2) cancellation provisions that trigger an obligation on the reporting entity to enter into a new reinsurance agreement with the reinsurer, (3) aggregate stop loss reinsurance coverage, (4) a unilateral right by either or both parties to commute the treaty, (5) a provision permitting reporting or payment of losses less frequently than on a quarterly basis, and (6) any features designed to delay timely reimbursement to the ceding entity.
Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

### Recent Accounting Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Source</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>FASB Statement No. 162 (May 2008)</td>
<td>The Hierarchy of Generally Accepted Accounting Principles</td>
</tr>
<tr>
<td>FASB Statement No. 161 (March 2008)</td>
<td>Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133</td>
</tr>
<tr>
<td>FASB Statement No. 160 (December 2007)</td>
<td>Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51</td>
</tr>
<tr>
<td>FASB Statement No. 141 (revised 2007) (December 2007)</td>
<td>Business Combinations</td>
</tr>
<tr>
<td>FASB Statement No. 158 (September 2006)</td>
<td>Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)</td>
</tr>
<tr>
<td>FASB Statement No. 157 (September 2006)</td>
<td>Fair Value Measurements</td>
</tr>
<tr>
<td>FASB Interpretation No. (FIN) 48 (June 2006)</td>
<td>Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109</td>
</tr>
<tr>
<td>FASB Staff Positions (FSPs) (Various dates)</td>
<td>Go to <a href="http://www.fasb.org/fasb_staff_positions/">www.fasb.org/fasb_staff_positions/</a> for a complete list of FSPs.</td>
</tr>
</tbody>
</table>
### Recent Accounting Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Document</th>
<th>Description</th>
</tr>
</thead>
</table>
| AICPA Statement of Position (SOP) 07-1 (AICPA, Technical Practice Aids, ACC sec. 10,930) | Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies. 
In February 2008, FASB issued FSP SOP 07-1-1, Effective Date of AICPA Statement of Position 07-1, which indefinitely defers the effective date of SOP 07-1. Entities that early adopted SOP 07-1 before December 15, 2007 are permitted, but not required, to continue to apply the provisions of the SOP. No other entities may adopt the provision of the SOP, subject to the exception in the following sentence: “If a parent entity that early adopted the SOP chooses not to rescind its early adoption, an entity consolidated by that parent entity that is formed or acquired after that parent entity’s adoption of the SOP must apply the provisions of the SOP in its standalone financial statements.” |
| Technical Questions and Answers (TIS) section 1100.15 (AICPA, Technical Practice Aids) | This question and answer discusses auditing and accounting issues related to withdrawal restrictions placed on short term investments by a money market fund or its trustee. |
| TIS sections 6910.25–.28 (AICPA, Technical Practice Aids) | These questions and answers discuss financial statement presentation considerations for investment companies. |
| TIS sections 6140.20–.22 (AICPA, Technical Practice Aids) | These questions and answers discuss not-for-profit organizations’ fund-raising expenses. |
| TIS sections 6931.08–.10 (AICPA, Technical Practice Aids) | These questions and answers discuss various employee benefit plan topics. |

.101 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance to the insurance industry are briefly explained here. The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. The Comprehensive Audit Risk Alert—2008 and other AICPA industry-specific alerts contain summaries of recent pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or visit www.cpa2biz.com.

### FASB Statement No. 163

.102 In May 2008, FASB issued FASB Statement No. 163, Accounting for Financial Guarantee Insurance Contracts—an interpretation of FASB Statement No. 60. The scope of FASB Statement No. 163 is limited to financial guarantee insurance and reinsurance contracts issued by enterprises included in FASB Statement No. 60. Financial guarantee insurance and reinsurance contracts obligate the insurance enterprise to pay a claim upon the occurrence of an event of default.

.103 This statement does not apply to enterprises excluded from FASB Statement No 60, financial guarantee insurance contracts that are accounted for as derivative instruments within the scope of FASB.
Statement No. 133, and some insurance contracts that are similar to financial guarantee insurance contracts issued by insurance enterprises (such as mortgage guaranty insurance and credit insurance on trade receivables). The changes to current practice are around premium revenue, claim liabilities, and disclosure requirements. The provisions of FASB Statement No. 163 should be applied on a contract-by-contract basis.

.104 At the inception of a financial guarantee insurance contract, a liability for the unearned premium revenue should be recognized, along with a premium receivable for the same amount. This initial measurement of the unearned premium revenue is the present value of the premiums due or, subject to certain criteria, expected to be collected over the contract period. The discount on the receivable should be accreted through earnings.

.105 The premium should be recognized as revenue over the contract period in proportion to the amount of insurance protection provided. As revenue is recognized, a corresponding decrease should occur in the unearned premium liability. For example, if there was a financial guarantee on a 10-year bond with periodic principal paydowns, the insurance enterprise would recognize more revenue in the earlier years as it is providing more protection (that is, insuring higher amounts of outstanding principal, which could possibly default).

.106 An insurance enterprise shall recognize a claim liability on a financial guarantee insurance contract when the insurance enterprise expects that a claim loss will exceed the unearned premium revenue for that contract based on the present value of expected net cash outflows to be paid under the insurance contract. Expected net cash outflows are probability weighted cash flows that reflect the likelihood of all possible outcomes of the insurance enterprise. This claim liability equals the present value of the contract’s expected net cash outflows discounted using a current risk free rate, which shall be based on the remaining period of the insurance contract. In periods after initial recognition of a claim liability, an insurance enterprise shall update the discount rate each reporting period. An insurance enterprise also shall revise expected net cash outflows when increases (or decreases) in the likelihood of a default (insured event) (and related amounts of net cash outflows) and potential recoveries occur. These revisions should be recognized as claim expense in the period of change (as a change in accounting estimate).

.107 Paragraph 29 of FASB Statement No. 163 also notes that an insurance enterprise should disclose information that enables readers of the financial statements to understand the factors affecting the present and future recognition and measurement of financial guarantee insurance contracts.

.108 FASB Statement No. 163 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. However, select disclosure requirements are effective for the first period (including interim periods) beginning after the issuance of this statement. Besides those select disclosures, early adoption is prohibited.

.109 Readers are encouraged to review the full text of FASB Statement No. 163 before applying its guidance, which can be found on the FASB Web site.

Business Combinations

.110 In December 2007, FASB issued FASB Statement No. 141 (revised 2007), Business Combinations, and FASB Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51. These standards strive not only to improve and simplify the accounting for business combinations and the reporting of noncontrolling interests in consolidated financial statements, but also to converge with international standards. The issuance of these standards marks the completion of FASB’s first major joint project with the IASB.

.111 FASB Statement No. 141(R) requires the acquiring entity in a business combination to recognize all the assets acquired and liabilities assumed in the transaction, with specific additional guidance regarding insurance and reinsurance contracts acquired in a business combination; establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; and requires the acquirer...
to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination.

.112 The specific guidance applicable to insurance and reinsurance contracts acquired in a business combination, provided by amendment to FASB Statement No. 60, requires all assets and liabilities arising from insurance and reinsurance contracts acquired in a business combination to be recognized at their acquisition-date fair values, with those fair values separated into (a) insurance and reinsurance GAAP accounting balances using the acquirer’s accounting policies and (b) an intangible asset (or, rarely, another liability). This approach enables the acquiring entity to subsequently report the acquired business on a basis consistent with its own written business. The amendments to FASB Statement No. 60 also clarify that the acquisition date assets and liabilities do not include certain of the acquiree’s accounts, such as deferred acquisition costs and unearned premiums that do not represent future cash flows. However, if under the acquirer’s accounting policies there would be an unearned premium reserve, these amendments would not preclude the acquirer from estimating that reserve in place of the acquiree’s unearned premium reserve.

.113 Additionally, FASB Statement No. 141(R) amends FASB Statement No. 109, Accounting for Income Taxes, to require that changes in a valuation allowance for an acquiree’s deferred tax asset, other than changes during the measurement period that result from new information about facts and circumstances that existed at the acquisition date, should be reported as a reduction or increase to income tax expense (or a direct adjustment to contributed capital in some circumstances). Although FASB Statement No. 141(R) is generally applicable on a prospective basis to business combinations for which the acquisition date is on or after December 15, 2008, this requirement will affect the accounting and reporting for changes in the valuation allowance for an acquiree’s deferred tax asset even for business combinations for which the acquisition date is prior to that date. As a result, auditors should be aware that companies may be working toward refining the valuation allowance for an acquiree’s deferred tax asset in the annual reporting period ending before implementation is required, during which time the companies would appropriately treat any such adjustment as an adjustment to goodwill, rather than as an income tax expense or benefit.

.114 FASB states that FASB Statement No. 141(R) also will decrease the complexity of existing GAAP because the new standard includes both core principles and application guidance, eliminating the need for other interpretive guidance. FASB Statement No. 141(R) is to be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply the standard before this date.

.115 FASB Statement No. 160 improves the relevance, comparability, and transparency of financial information by requiring all entities to report noncontrolling (minority) interests in subsidiaries in the same way—as equity in the consolidated financial statements. FASB Statement No. 160 also eliminates the diversity in accounting for transactions between an entity and noncontrolling interests by requiring they be treated as equity transactions. FASB Statement No. 160 is effective for fiscal years and interim periods within those fiscal years, beginning on or after December 15, 2008 (for calendar year-end companies January 1, 2009). Earlier adoption is prohibited. The standard is applied prospectively as of the beginning of the fiscal year in which the statement is initially applied, except for the presentation and disclosure requirements. Presentation and disclosure requirements should be applied retroactively for all periods presented.

Recent AICPA Independence and Ethics Pronouncements

.116 Audit Risk Alert Independence and Ethics Developments—2008 (product no. 022479kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.
On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to the insurance industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

The following table lists the various standard setting bodies’ Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.

<table>
<thead>
<tr>
<th>Standard-Setting Body</th>
<th>Web Site</th>
</tr>
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<tbody>
<tr>
<td>AICPA Auditing Standards Board (ASB)</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/</a></td>
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<tr>
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<td>National Association of Insurance Commissioners (NAIC)</td>
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<td>Professional Ethics Executive Committee (PEEC)</td>
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</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
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</tr>
</tbody>
</table>

Overhaul Project—AICPA Audit and Accounting Guide Property and Liability Insurance Companies

The AICPA is continuing to make progress overhauling the AICPA Audit and Accounting Guide Property and Liability Insurance Companies, addressing numerous accounting, auditing, industry, and regulatory issues that have transpired since this guide was originally issued in 1990. During this project, the AICPA will continue to issue annual editions of the guide, updated to reflect recent audit and accounting pronouncements.

Auditing Pipeline—Nonissuers

ASB Clarity Project

In response to growing concerns about the complexity of standards, the Auditing Standards Board (ASB) has commenced a large-scale “clarity” project to revise all existing auditing standards so they are easier to read and understand. Over the next two or three years, the ASB will be redrafting all of the existing auditing sections contained in the Codification of Statements on Auditing Standards (AU sections of the AICPA’s Professional Standards), to apply the clarity drafting conventions and to converge with the International Standards on Auditing issued by the International Auditing and Assurance Standards Board. The ASB proposes that, except to address current issues, all redrafted standards will become effective at the same time. Only those standards needing to address current issues would have earlier effective dates. The ASB believes that a single effective date will ease the transition to, and implementation of, the redrafted standards.
standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. Currently, the date is expected to be for audits of financial statements for periods beginning no earlier than December 15, 2010. This date depends on satisfactory progress being made, and will be amended should that prove necessary. See the Clarity Project Explanatory Memorandum and the discussion paper Improving the Clarity of ASB Standards at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm.

Auditing Pipeline—Issuers

.121 Guidance issued by the PCAOB is included in the section of this alert titled “Summary of Recent Auditing and Attestation Pronouncements and Related Guidance.” For more information regarding recent developments at both the SEC and PCAOB, readers may refer to Audit Risk Alert SEC and PCAOB Developments—2008.

Accounting Pipeline

.122 A number of accounting projects and pronouncements are currently in progress. For a summary of significant accounting projects and pronouncements, refer to the Comprehensive Audit Risk Alert—2008 (product no. 022339kk). Such in-progress issues include the following:

- Accounting for hedging activities exposure draft
- Accounting for contingencies exposure draft
- Phase 2 of the fair value project
- Transfers of financial assets project
- Earnings per share convergence project
- Income tax convergence project
- Leases project
- Reporting discontinued operations project
- Going concern proposed statement
- Subsequent events proposed statement
- Amendments to FIN 46(R) proposed statement

IASB Insurance Contracts Phase II

.123 The IASB is currently working on phase II of the insurance contracts project, which will provide a basis for consistent accounting for insurance contracts on the longer term. In February 2008, the IASB started its review of responses to the discussion paper preliminary views on insurance contracts. At their April 2008 meeting, the insurance working group provided input for a number of issues that followed from the responses to the discussion paper. During their September 2008 meeting, the working group discussed the notion advocated by respondents regarding a measurement that reflects the fact that the insurer intends (and in most cases must) settle the liability by paying the contractual benefits as they become due, rather than by transferring the liability to a third party; however, no decisions were reached. The next meeting of the insurance working group will take place in November 2008. FASB does not have this as a current project item, but lists it as an IASB project that is monitored by the FASB staff.

Proposed FASB Emerging Issues Task Force Issues and Staff Positions

.124 Proposed FASB EITF Issues. Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.
Proposed FASB Staff Positions (FSPs). A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

Resource Central

The following are various resources that practitioners engaged in the insurance industry may find beneficial.

Publications

Practitioners may find the following publications useful. Choose the format best for you—online, print, or CD-ROM.

- Audit and Accounting Guide Life and Health Insurance Entities (2008) (product no. 012638kk [paperback], WLH-XXkk [online], or DLH-XXkk [CD-ROM])
- Audit and Accounting Guide Property and Liability Insurance Companies (2008) (product no. 012678kk [paperback], WPL-XXkk [online], or DPL-XXkk [CD-ROM])
- Audit Guide Analytical Procedures (2008) (product no. 012558kk [paperback], WAN-XXkk [online], or DAN-XXkk [CD-ROM])
- Audit Guide Assessing and Responding to Audit Risk In a Financial Statement Audit (2006) (product no. 012456kk [paperback] or WRA-XXkk [online])
- Audit Guide Auditing Derivative Instruments, Hedging Activities, and Investments in Securities (2008) (product no. 012528kk [paperback], WDI-XXkk [online], or DDI-XXkk [CD-ROM])
- Audit Guide Auditing Revenue in Certain Industries (2008) (product no. 012518kk [paperback], WAR-XXkk [online], or DAR-XXkk [CD-ROM])
- Audit Guide Audit Sampling (2008) (product no. 012538kk [paperback], WAS-XXkk [online], or DAS-XXkk [CD-ROM])
- Audit Guide Service Organizations: Applying SAS No. 70, as Amended (2008) (product no. 012778kk [paperback], WSV-XXkk [online], or DSV-XXkk [CD-ROM])
- Comprehensive Audit Risk Alert—2008 (product no. 022339kk [paperback], WGE-XXkk [online], or DGE-XXkk [CD-ROM])
- Audit Risk Alert Independence and Ethics Developments—2008 (product no. 022479kk [paperback], WIA-XXkk [online], or DIA-XXkk [CD-ROM])
- Audit Risk Alert SEC and PCAOB Developments—2008 (product no. 022499kk [paperback])
- Audit Risk Alert Understanding the New Auditing Standards Related to Risk Assessment (product no. 022526kk [paperback])
- Checklists and Illustrative Financial Statements for Life & Health Insurance Companies (product no. 008958kk [paperback] or WLI-CLkk [online])
- Checklists and Illustrative Financial Statements for Property & Liability Insurance Companies (product no. 008968kk [paperback] or WPI-CLkk [online])
- Audit and Accounting Manual (2008) (product no. 005138kk [paperback], WAM-XXkk [online], or AAM-XXkk [loose leaf])
- Accounting Trends & Techniques, 62nd Edition (product no. 009900kk [paperback] or WAT-XXkk [online])

Additional resources for accountants in business and industry are the Financial Reporting Alert series, designed to be used by members of an entity’s financial management and audit committee to identify and understand current accounting and regulatory developments affecting the entity’s financial reporting.
• Financial Reporting Alert Current Accounting Issues and Risks—2008 (product no. 029208kk [paperback])
• Financial Reporting Alert FASB Codification Developments—2008 (product no. 029209kk [paperback])

AICPA reSOURCE: Accounting and Auditing Literature

.129 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm’s needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to the AICPA’s latest Professional Standards, Technical Practice Aids, Audit and Accounting Guides (more than 20), Audit Risk Alerts (more than 15), and Accounting Trends & Techniques. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Continuing Professional Education

.130 The AICPA offers a number of CPE courses that are valuable to CPAs working in public practice and industry, including the following:

• AICPA’s Annual Accounting and Auditing Update Workshop (2008–2009 Edition) (product no. 736184kk [text] or 187192kk [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.

• SEC Reporting (product no. 736775kk [text] or 186756kk [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements in addition to giving you examples and tips for ensuring compliance.

• International Versus U.S. Accounting: What in the World is the Difference? (product no. 731666kk [text]). With the fast pace of the convergence project, understanding the differences between IFRS and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRS and U.S. GAAP.

• The International Financial Reporting Standards: An Overview (product no. 157220kk [online] or 739750HSkk [DVD]). This course captures a live presentation on IFRS given to the AICPA Board of Directors.

.131 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.132 AICPA CPEExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz, is the AICPA’s flagship online learning product. AICPA members pay $180 for a new subscription and $149 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPEExpress offers hundreds of hours of learning in a wide variety of topics.

.133 To register or learn more, visit www.cpa2biz.com.

Webcasts

.134 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession’s leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.
CFO Quarterly Roundtable Series

.135 The CFO Quarterly Roundtable Series, brought to you each calendar quarter via webcast, covers a broad array of “hot topics” that successful organizations employ and subjects that are important to the CFO’s personal success. From financial reporting, budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.136 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession’s leading experts on what is “hot” at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you “plugged in” to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.137 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.138 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA’s Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. Beginning January 14, 2008, hotline hours were extended so that the hotline is now available from 9 a.m. to 8 p.m. on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/.

Ethics Hotline

.139 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA’s Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077.

The Center for Audit Quality

.140 The Center for Audit Quality (CAQ), which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ’s mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession’s core values of integrity, objectivity, honesty, and trust.

.141 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit http://thecaq.aicpa.org.
AICPA Industry Expert Panel—Insurance

.142 For information about the activities of the AICPA Insurance Industry Expert Panel, visit the panel’s Web page at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_insurance.htm.

Industry Web Sites

.143 The Internet covers a vast amount of information that may be valuable to auditors of insurance entities, including current industry trends and developments. Some of the more relevant sites for auditors with insurance clients include those shown in the following table:

<table>
<thead>
<tr>
<th>Organization</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama Insurance Underwriting Association (AIUA)</td>
<td><a href="http://www.alabamabeachpool.org">www.alabamabeachpool.org</a></td>
</tr>
<tr>
<td>Citizens Property Insurance Corporation of Florida (Florida Citizens)</td>
<td><a href="http://www.citizensfla.com">www.citizensfla.com</a></td>
</tr>
<tr>
<td>Florida Hurricane Catastrophe Fund (FHCF)</td>
<td><a href="http://www.sbafla.com/fhcf">www.sbafla.com/fhcf</a></td>
</tr>
<tr>
<td>Insurance Information Institute (III)</td>
<td><a href="http://www.iii.org">www.iii.org</a></td>
</tr>
<tr>
<td>Louisiana Citizens Property Insurance Corporation</td>
<td><a href="http://www.lacitizens.com">www.lacitizens.com</a></td>
</tr>
<tr>
<td>Mississippi Residential Property Insurance Underwriting Association (MRPIUA)</td>
<td><a href="http://www.msplans.com/MRPIUA">www.msplans.com/MRPIUA</a></td>
</tr>
<tr>
<td>Mississippi Windstorm Underwriting Association (MWUA)</td>
<td><a href="http://www.msplans.com/mwua">www.msplans.com/mwua</a></td>
</tr>
<tr>
<td>National Association of Insurance Commissioners (NAIC)</td>
<td><a href="http://www.naic.org/">www.naic.org/</a></td>
</tr>
<tr>
<td>Texas Windstorm Insurance Association (TWIA)</td>
<td><a href="http://www.twia.org">www.twia.org</a></td>
</tr>
</tbody>
</table>

.144 The insurance practices of some of the larger CPA firms may also contain industry-specific auditing and accounting information that is helpful to auditors.

* * * *

.145 This Audit Risk Alert replaces Insurance Industry Developments—2007/08.

.146 The Audit Risk Alert Insurance Industry Developments is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year’s Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to madams@aicpa.org or write to

Michele C. Adams, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110
Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

<table>
<thead>
<tr>
<th>Web Site Name</th>
<th>Content</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>American Institute of CPAs (AICPA)</td>
<td>Summaries of recent auditing and other professional standards as well as other AICPA activities</td>
<td><a href="http://www.aicpa.org">www.aicpa.org</a>, <a href="http://www.cpa2biz.com">www.cpa2biz.com</a>, <a href="http://www.ifrs.com">www.ifrs.com</a></td>
</tr>
<tr>
<td>AICPA Accounting Standards Executive Committee (AcSEC)</td>
<td>Issues guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards</a></td>
</tr>
<tr>
<td>AICPA Professional Issues Task Force (PITF)</td>
<td>Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards+Professional+Issues+Task+Force">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards+Professional+Issues+Task+Force</a></td>
</tr>
<tr>
<td>Economy.com</td>
<td>Source for analyses, data, forecasts, and information on the United States and world economies</td>
<td><a href="http://www.economy.com">www.economy.com</a></td>
</tr>
<tr>
<td>The Federal Reserve Board</td>
<td>Key interest rates</td>
<td><a href="http://www.federalreserve.gov">www.federalreserve.gov</a></td>
</tr>
<tr>
<td>Financial Accounting Standards Board (FASB)</td>
<td>Summaries of recent accounting pronouncements and other FASB activities</td>
<td><a href="http://www.fasb.org">www.fasb.org</a></td>
</tr>
<tr>
<td>USA.gov</td>
<td>Portal through which all government agencies can be accessed</td>
<td><a href="http://www.usa.gov">www.usa.gov</a></td>
</tr>
<tr>
<td>International Accounting Standards Board (IASB)</td>
<td>Summaries of International Financial Reporting Standards and International Accounting Standards</td>
<td><a href="http://www.iasb.org">www.iasb.org</a></td>
</tr>
<tr>
<td>International Auditing and Assurance Standards Board (IAASB)</td>
<td>Summaries of International Standards on Auditing</td>
<td><a href="http://www.iaasb.org">www.iaasb.org</a></td>
</tr>
<tr>
<td>International Federation of Accountants (IFAC)</td>
<td>Information on standards setting activities in the international arena</td>
<td><a href="http://www.ifac.org">www.ifac.org</a></td>
</tr>
<tr>
<td>Web Site Name</td>
<td>Content</td>
<td>Web Site</td>
</tr>
<tr>
<td>---------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>------------</td>
</tr>
<tr>
<td>Private Company Financial Reporting Committee (PCFRC)</td>
<td>Information on the initiative to further improve FASB's standard setting process to consider needs of private companies and their constituents of financial reporting</td>
<td><a href="http://www.pcfr.org">www.pcfr.org</a></td>
</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
<td>Information on accounting and auditing activities of the PCAOB and other matters</td>
<td><a href="http://www.pcaob.org">www.pcaob.org</a></td>
</tr>
</tbody>
</table>

[The next page is 8139.]
AAM Section 8050

Depository and Lending Institution Industry Developments—2008

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of banks, credit unions, and other financial institutions with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an other auditing publication as defined in AU section 150, Generally Accepted Auditing Standards (AICPA, Professional Standards, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Technical Manager
Accounting and Auditing Publications

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How This Alert Helps You

This Audit Risk Alert (alert) helps you plan and perform your audits of financial institutions and other lenders. This alert can also be used by an entity’s internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool in helping you identify the significant risks that may result in the material misstatement of financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.
This alert is intended to be used in conjunction with Comprehensive Audit Risk Alert—2008 (product no. 022339kk). This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor’s understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity’s financial performance
- Internal control, which includes the selection and application of accounting policies

The financial institutions industry may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

The auditor should obtain an understanding of the entity’s objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity’s ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity’s business is also dynamic, and the entity’s strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client’s environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic and Industry Developments

The State of the Economy

When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on the entity’s financial statements being audited.
Unprecedented Events in the Financial Markets

During 2008, unprecedented events occurred in the financial markets, including the failure of a major investment bank, acquisitions of several investment and commercial banks (including some that required assistance from federal agencies), and the placement into conservatorship of Fannie Mae and Freddie Mac. Further, several foreign financial institutions received assistance from their national governments, or entered into similar acquisition agreements. Additionally, on September 17, 2008, a significant, publicly registered money market fund declined below the industry standard of $1.00 per share on a market value basis due to a combination of holdings of short-term securities issued by the failed investment bank and major shareholder redemptions. As a result of these events, the condition of the fixed income markets worsened. Corporations and financial institutions generally recognized as creditworthy began experiencing difficulty borrowing money in the financial markets for any longer than an overnight basis. Of primary concern to depository institutions was the decline in liquidity faced by the industry.

The following sections detail some of the recent events that have affected the financial markets.

Lehman Brothers

Many believed that the U.S. government would bail out Lehman, as it had Freddie Mac and Fannie Mae. However, the government took a tougher stance with Lehman, as it refused to provide a financial backstop to investors. As Lehman’s future looked bleak, it became clear that the best option was for Wall Street firms to create a solution in which financing would be provided to carve out some of Lehman’s real estate exposure. Lehman’s decline was due, in part, to over exposure in real-estate investments.

Merrill Lynch

As Bank of America backed off a purchase offer of Lehman, the bank began to consider Merrill Lynch as a potential acquisition. The Bank of America deal calls for a purchase price of $29 per share, for $44 billion total.

American International Group

On September 16, 2008, the U.S. Federal Reserve Bank (FRB), with the full support of the U.S. Department of the Treasury, authorized the FRB of New York to lend up to $85 billion to the American International Group (AIG) under Section 13(3) of the Federal Reserve Act. Terms and conditions of the secured loan are designed to protect the interest of the U.S. government and taxpayers. The FRB determined a chaotic failure of AIG could add to already significant levels of financial market fragility. The purpose of this liquidity facility is to assist AIG in meeting its obligations as they come due. This loan will facilitate a process under which AIG will sell some of its businesses in an orderly manner, with the least possible disruption to the overall economy. The loan is expected to be repaid from the proceeds of the sale of the firm’s assets. The U.S. government will receive a 79.9 percent equity interest in AIG and has the right to veto the payment of dividends to common and preferred shareholders.

Development of New Alert to Address Current Market Conditions

This alert discusses the current economic environment (including basic measures of economic activity) and the economy’s effect on the financial institutions industry. In light of the economic situation, the AICPA is developing a dedicated alert to address common accounting and auditing concerns relative to current market conditions. Specifically, the alert will discuss resources to assist in fair value accounting and its associated audit risks. Until that alert is published, we encourage you to remain current on economic happenings. Please visit www.cpa2biz.com for upcoming AICPA products, including the alert mentioned here, to help navigate this trying time.
Basic Measures of Economic Activity—Gross Domestic Product, Unemployment, and Interest Rates

The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.2 percent in 2007. According to 2008 third quarter advance estimates, real GDP decreased at an annual rate of 0.3 percent, which is down significantly from the 2.8 percent increase in real GDP during the second quarter of 2008.

The unemployment rate remained relatively unchanged during 2007, holding between 4.4 percent and 5.0 percent, with an annual average rate of 4.6 percent. However, during 2008, the unemployment rate has risen. As of October 2008, the unemployment rate was 6.5 percent, representing approximately 10.1 million people.

The target for the federal funds rate remained stable at 5.25 percent from June 2006 to September 2007, when the Federal Reserve began decreasing rates. Since the first rate decrease in September 2007, the Federal Reserve has decreased rates a total of 4.25 percentage points to 1.00 percent as of the end of October 2008. The Federal Reserve noted in its October press release that the pace of economic activity appears to have slowed markedly, owing importantly to a decline in consumer expenditures. Business equipment spending and industrial production have weakened in recent months, and slowing economic activity in many foreign economies is damping the prospects for U.S. exports. Moreover, the intensification of financial market turmoil is likely to exert additional restraint on spending, partly by further reducing the ability of households and businesses to obtain credit. Inflation has been high, but the Federal Open Market Committee, which sets the nation’s monetary policy, believes that the decline in energy and other commodity prices and the weaker prospects for economic activity have reduced the upside risks to inflation.


The EESA is intended to restore financial sector liquidity and stability, protect the value of taxpayer assets (such as homes, savings and retirement funds) and provide a return to taxpayers. The EESA authorizes the Treasury secretary to establish the Troubled Assets Relief Program (TARP), whereby the U.S. Treasury can purchase troubled assets from financial institutions, and authorizes $700 billion as requested by the Treasury secretary for the implementation of TARP. Upon authorization of TARP, up to $350 billion became available for immediate use. The secretary is required to examine the long-term viability of an institution in determining whether to directly purchase assets under TARP. Financial institutions participating in TARP will be subject to certain restrictions on executive compensation.

At the time this alert was written, the Treasury had not acquired any assets under TARP, but the Treasury had released the terms of its Capital Purchase Program (CPP) and had finalized certain transactions under the CPP.

Under the CPP, the Treasury proposed to invest up to $250 billion in senior perpetual preferred stock and warrants in qualifying financial institutions. In November 2008, the Treasury completed its $125 billion aggregate investment in the nine banking organizations deemed to be systemically important. Funds received from the CPP will be includible in an institution’s Tier 1 capital without limitation. Other institutions were required to apply by November 14, 2008 to their appropriate federal banking agency for participation in the program. The deadline for nonpublic stock institutions and mutual banks has been extended as the Treasury develops term sheets applicable to these institutions.
Among other things, the EESA

- requires the Securities and Exchange Commission (SEC), in consultation with the Federal Reserve and Treasury, to conduct a study on mark-to-market accounting standards as provided in Financial Accounting Standards Board (FASB) Statement No. 157, *Fair Value Measurements*, and to report to Congress within 90 days on its findings.

- raises the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Share Insurance Fund (NCUSIF) deposit insurance limits from $100,000 per account to $250,000 until December 31, 2009, and temporarily raises the borrowing limits at the Treasury for the FDIC and the NCUSIF.

- details certain changes in the tax treatment (from capital to ordinary) of losses on the preferred stock of Freddie Mac and Fannie Mae for financial institutions.

- applies limits on executive compensation and golden parachutes for certain executives of employers who participate in the auction program.

- extends current law tax forgiveness on the cancellation of mortgage debt.

For additional information on the EESA and its related programs, see http://treasury.gov/initiatives/eesa/. On that Web site, you may also sign up for EESA e-mail alerts to receive notification about current developments.

**Industry Trends and Conditions**

The current economic conditions and resulting government intervention is directly and significantly affecting the financial institutions industry. This section of the alert includes information on the state of the financial institution, banking, credit union, financial services, and mortgage industries and then turns to a discussion of the unprecedented events occurring in the industry through the date of this writing.

**The State of the Financial Institutions Industry**

According to the FDIC Quarterly Banking Profile issued for the second quarter of 2008, insured commercial banks and savings institutions reported net income of $5.0 billion for the second quarter of 2008, the second-lowest quarterly total since 1991 and $31.8 billion (86.5 percent) less than the industry earned in the same period of the prior year. The decrease in earnings was primarily driven by higher loan-loss provisions, which totaled $50.2 billion for the period. This is more than four times the $11.4 billion quarterly total from one year ago.

The average return on assets (ROA) in the second quarter of 2008 was 0.15 percent, compared to 1.21 percent from one year earlier. For institutions with assets greater than $1 billion, the average ROA in the second quarter was 0.10 percent, down from 1.23 percent a year ago. More than half of all insured institutions reported year-over-year declines in quarterly net income, and almost two out of every three institutions, or 62 percent, reported lower ROAs. Almost 18 percent of all insured institutions were unprofitable in the second quarter, compared to only 9.8 percent in the second quarter of 2007.

Loan losses increased significantly during the second quarter of 2008, as loss rates on real estate loans increased sharply. Net charge-offs of loans and leases totaled $26.4 billion in the second quarter of 2008, which is three times the $8.9 billion charged off in the second quarter of 2007. The annualized net charge-off rate in the second quarter was 1.32 percent, compared to 0.49 percent a year earlier and represents the highest quarterly charge-off rate for the industry since the fourth quarter of 1991.

The number of institutions filing quarterly financial reports fell to 8,451 at the end of the second quarter of 2008, down from 8,494 at the end of the first quarter of 2008. Twenty-four new charters were added during the second quarter of 2008, while 64 existing charters were merged into other institutions. Two insured institutions failed during the quarter, bringing the total for the first six months of 2008 to four failures. Three mutually owned savings banks, with combined assets of $1.1 billion, converted to stock...
ownership in the second quarter. The number of institutions on the FDIC’s “Problem List” increased from 90 to 117 during the quarter. Assets of “problem” institutions increased from $26.3 billion to $78.3 billion.

The State of the Banking Industry

Other-Than-Temporary Impairments

In a September 2008 press release, several banks expressed concern over the accounting application of other than temporary impairments based on preferred securities, collateralized mortgage obligations, and other mortgage backed securities by auditors. The main issue is the accounting treatment of mortgage and other debt investments whose values decline so much that financial institutions might not be able to recoup what they paid for them. Although the accounting treatment is subjective, many auditors are pressuring banks to record the investments as impaired. Banks disagree with the accounting treatment being applied by some auditors, stating that they are still able to collect principal and interest on the investments. In some cases, banks have expressed the belief that the battered securities will rebound in the future.

FASB Staff Position (FSP) FAS 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary and Its Application to Certain Investments, addresses the determination concerning when an investment is considered impaired, whether the impairment is other than temporary, and the measurement of the impairment loss. Also included in the FSP are accounting considerations subsequent to the recognition of other than temporary impairment and related disclosures about unrealized losses as a result of the other than temporary impairment. The FSP amends FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, FASB Statement No. 124, Accounting for Certain Investments Held by Not for Profit Organizations, and Accounting Principles Bulletin (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock. The FSP also nullifies certain requirements of Emerging Issues Task Force (EITF) Issue No. 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,” and supersedes EITF Topic No. D-44, “Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value.” The FSP provides the following guidance:

• Determine whether an investment is impaired.
• Evaluate whether an impairment is other than temporary.
• If the impairment is other than temporary, recognize an impairment loss equal to the difference between the investment’s cost and its fair value.

It is important for auditors and financial institutions to understand when an investment is impaired and may require specific treatment under the FSP. For more information on the FSP, please visit the FASB Web site.

EITF Issue No. 99-20

Recognition and potential impairment issues continue to arise based on the continued complexity of financial institution investments. EITF Issue No. 99-20, “Recognition of Interest Income and Impairment on Purchased Beneficial Interest and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets,” addresses how a transferor that continues to hold an interest in securitized financial assets, or an enterprise that purchases a beneficial interest in securitized financial assets, should account for interest income and impairment. FASB reached the following consensuses in development of this EITF issue:

• The holder should recognize the excess of all cash flows attributable to the beneficial interest estimated at the acquisition or transaction date over the initial investment as interest income over the life of the beneficial interest using the effective yield method.
• The holder of a beneficial interest should continue to update the estimate of cash flows over the life of the beneficial interest.
• All cash flows estimated at the transaction date are defined as the holder’s estimate of the amount and timing of estimated future principal and interest cash flows used in determining the purchase price or the holder’s fair value determination for purposes of determining a gain or loss under FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.

• An entity should retain the available for sale classification of the interest that continues to be held by a transferor and should not recognize as interest income over the life of that interest that continues to be held by a transferor unless a portion of the unrealized gain or loss recorded in other comprehensive income must be included in income as a component of the recognition of an other-than-temporary impairment.

• When an entity intends to sell a specifically identified beneficial interest classified as available for sale at a loss shortly after the balance sheet date whose fair value is less than its carrying amount and the entity does not expect the fair value to recover prior to the expected time of the sale, a write-down for other-than-temporary impairment should be recognized in earnings in the period in which the decision to sell is made.

• When it is not practicable for a transferor to estimate the fair value of the beneficial interest at the initial transfer date, interest income should not be recognized using the interest method. In those instances, the cash basis for recognizing interest income should be used.

.33 The EITF issue does not address when a holder of a beneficial interest would place the interest on nonaccrual status or when a holder cannot reliably estimate cash flows. For more information on this EITF issue, please visit the FASB Web site.

Measurements of Fair Value in Illiquid Markets

.34 Most of the subprime mortgages making headlines were ultimately financed via securitization issuances. As a result of the growing numbers of defaults and foreclosures and uncertainty about the future, investors in these securities and lenders who issued these securities have almost come to a standstill, causing a liquidity crisis. This has caused significant declines in the values of existing loans and mortgage backed securities held by both lenders and investors given the lack of demand. This has also spread to a lack of demand for investments in collateralized debt obligations, as many hold securities backed by subprime mortgages, and even the short-term commercial paper market.

.35 Given the state of the market, there is confusion around the use of market quotes and whether current market prices represent fair value in accordance with FASB Statement No. 157 or are, in actuality, distressed sales. To clarify the application of FASB Statement No. 157 in an inactive market, FASB issued FSP FAS 157-3. This FSP also amends FASB Statement No. 157 to include an illustrative example. FSP FAS 157-3 noted the consistency between the guidance provided in it and the guidance provided in the SEC and FASB press release. Readers are encouraged to review the full text of the FSP and the amended standard (inclusive of its recently added illustrative example) on the FASB Web site at www.fasb.org. The FSP was effective upon issuance, including any prior periods for which financial statements have not been issued. Any revisions from changes in valuation techniques or their application shall be accounted for as a change in accounting estimate in accordance with FASB Statement No. 154, Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3; however, the disclosure provisions of FASB Statement No. 154 for such revisions are not required.

.36 FSP FAS 157-3 noted that broker (or pricing service) quotes may be an appropriate input when measuring fair value, but they are not necessarily determinative if an active market does not exist for the financial asset. ... In weighing a broker quote as an input to a fair value measurement, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence.
As discussed in paragraph 7 of FASB Statement No. 157, an orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

Low transaction volume involving such assets does not necessarily translate into forced sales, nor does it necessarily mean the market is inactive. To deem a transaction forced or disorderly, persuasive evidence and judgment are required.

If transaction volume is too low to provide accurate pricing information and therefore a level 1 input, those observable transactions are to be considered level 2 inputs or even level 3 inputs if they are significantly adjusted. The Center for Audit Quality’s (CAQ) October 2007 white paper on the topic noted some characteristics of an inactive market are “few transactions for the asset, the prices are not current, price quotations vary substantially, or in which little information is released publicly.” The SEC and FASB also described an inactive market. Their press release noted that “a significant increase in the spread between the amount sellers are ‘asking’ and the price that buyers are ‘bidding’, or the presence of a relatively small number of ‘bidding’ parties, are indicators that should be considered in determining whether a market is inactive.”

The lack of an active market and the information obtained from it require further analysis. According to FSP FAS 157-3, “in cases where the volume and level of trading activity in the asset have declined significantly, the available prices vary significantly over time or among market participants, or the prices are not current, the observable inputs might not be relevant and could require significant adjustment.” Further, the SEC and FASB press release noted, “in some cases using unobservable inputs (level 3) might be more appropriate than using observable inputs (level 2); for example, when significant adjustments are required to observable inputs, it may be appropriate to utilize an estimate based primarily on unobservable inputs.” When significant adjustments are made to an observable input (level 2), it becomes a level 3 fair value measurement.

Paragraph C85 of FASB Statement No. 157 states, “the reporting entity may use its own data to develop unobservable inputs, provided that there is no information reasonably available without undue cost and effort that indicates that market participants would use different assumptions in pricing the asset or liability.” A reporting entity is prohibited from ignoring observable transaction or assumptions that are reasonably available without undue cost and effort.

The FSP concluded, “the use of a reporting entity’s own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available.” Similarly, the SEC and FASB press release noted the following:

In some cases, multiple inputs from different sources may collectively provide the best evidence of fair value. In these cases, expected cash flows would be considered alongside other relevant information. The weighting of the inputs in the fair value estimate will depend on the extent to which they provide information about the value of an asset or liability and are relevant in developing a reasonable estimate.

The AICPA, in October 2008 (as mentioned previously in this alert), issued a nonauthoritative Technical Practice Aid (TPA) about liquidity restrictions. Technical Questions and Answers (TIS) section 1100.15, “Liquidity Restrictions” (AICPA, Technical Practice Aids), provides useful information to accountants and auditors when an entity’s short-term investments (such as money market funds) have become restricted by the fund (or its trustee). The full TPA can be obtained from the AICPA’s Web site.

Beige Book Report

on current economic conditions gathered by each FRB by district and sector. The October 2008 report noted the following:

- Credit conditions were tight across all districts, with several reporting reduced credit availability for both financial and nonfinancial institutions.
- Bank lending was stable or lower for both consumers and businesses.
- Lenders had become more cautious and more conservative.
- Customers were taking steps to ensure that existing deposits were covered by insurance and noted deposit withdrawals after reports of bank closings during September 2008.
- Liquidity problems existed in interbank markets along with a higher cost of funds in several districts.
- Businesses having difficulties in obtaining credit were also reported in several districts.

As auditors perform their risk assessment, the Beige Book is a useful resource to understand the environment in which depository and lending institutions are operating and how current conditions may affect the assessment of the risks of material misstatement of the financial statements. For more information and the latest Beige Book report, visit www.federalreserve.gov/fomc/beigebook/2008/.

2008 Senior Loan Officer Opinion Survey

The Federal Reserve conducts a Senior Loan Officer Opinion Survey quarterly for availability in January and February, April and May, August, and October and November to coincide with the meetings of the Federal Open Market Committee. The Federal Reserve occasionally conducts one or two additional surveys annually. These reports can be obtained at www.federalreserve.gov/boarddocs/SnLoanSurvey/.

The October 2008 report noted several developments, including the following:

- Approximately 85 percent of domestic banks reported having tightened lending standards on commercial and industrial (C&I) loans to large and middle market firms since July 2008. Approximately 75 percent noted having tightened lending standards on C&I loans to small firms during the same 3 month period.
- Approximately 95 percent of U.S. banks reported having tightened the costs of credit lines to large and medium-sized firms; nearly 90 percent reported such tightening for smaller firms.
- Approximately 70 percent of U.S. branches and agencies of foreign banks indicated that they had tightened their lending standards on C&I loans since July 2008.
- Approximately 15 percent of domestic respondents reported a reduction in demand for C&I loans from large and middle-market firms; 5 percent reported a weakening in demand from smaller firms. However, 5 percent, on net, of the U.S. branches and agencies of foreign banks actually reported an increase in demand for C&I loans.

Consumer Credit Increase

According to the FRB, consumer credit increased at an annual rate of 1.25 percent in the third quarter of 2008 with revolving credit increasing 2.5 percent and nonrevolving credit increasing 0.50 percent during the quarter. This data is released on the 5th of each month and can be accessed at www.federalreserve.gov/Releases/G19/.

Navigating the Credit Storm

From faltering credit lines at megabanks to weakening credit lines, the U.S. credit crisis continues to affect the industry and the overall economy. To address this issue, many U.S. banks are altering their underwriting and pricing practices. Bankers across the nation predict an increase in losses due to credit card
fraud, commercial loan losses, and an increase in foreclosures during 2008. To offset these losses, many banks have begun to tighten their underwriting standards. Federal regulators have also proposed new appraisal guidelines for depositary and lending institutions. See the “Proposed Interagency Appraisal and Evaluation Guidelines” section of this alert for further discussion of this topic. Auditors should obtain an understanding of the internal controls surrounding the underwriting process and inquire of any changes to those controls as a result of the current economic environment.

The State of the Credit Union Industry

.50 On August 20, 2008, the National Credit Union Association (NCUA) reported that the overall financial condition of federally insured credit unions remains strong. Call report data submitted by the nation’s 7,972 federally insured credit unions showed that assets, loans, shares, and membership demonstrated consistent growth through the first 6 months of the year ending June 30, 2008.

.51 Membership grew to approximately 88 million in federally insured credit unions, and transposing recent trends, savings outpaced lending in the first 6 months of 2008. Savings grew a substantial 7.0 percent, lending grew 3.7 percent, and assets increased 6.5 percent from January to June.

.52 The loan to share ratio remains high at 80.72 percent. With the exception of declines in new automobile and other unsecured loans and lines of credit, all major loan categories grew from December 2007 to June 2008. In addition to the 10.1 percent increase in first mortgage real estate loans, which represent $198.1 billion, other types of real estate loans reported 1.7 percent growth to $92.8 billion, used automobile loans grew 3.3 percent to $92.0 billion, unsecured credit card loans grew 1.5 percent to $30.6 billion, and all other loans and lines of credit grew to $25.6 billion.

.53 The loan delinquency ratio increased 4 basis points, up from 0.93 percent to 0.97 percent, and the net charge-off ratio increased from 0.51 percent to 0.71 percent during the first 6 months of 2008. The ROA ratio declined from 0.64 percent to 0.52 percent primarily due to increased funds set aside for loan and lease losses. With savings growth outpacing loan growth in 2008, the loan-to-share ratio declined to 80.72 percent from 83.32 percent at year-end 2007.


False Filing of Identity Theft to Improve Credit Rating

.55 In April 2008, the NCUA issued a warning to credit unions concerning a scam that involves falsely filing an identity theft claim in order to improve one’s credit report and credit score. The perpetrators claim identity theft and as a result file police reports, causing disputed accounts to be removed from their credit reports. This improves credit reports and scores dramatically. The improved credit scores allow the perpetrators to obtain additional credit and loans that then go unpaid.

.56 Precautions should be taken when a credit report is obtained that reflects that a person has been the victim of identity theft. Credit union personnel should be aware that the loan applicant should be able to prove that he or she was a victim of identity theft. Proof of identity theft includes the names of credit bureaus that were notified, a police report, and a list of disputed accounts.

.57 Management must ensure they file a suspicious activity report when they believe their credit union has been the victim of the identity theft scam. Part 748 of the NCUA Rules and Regulations instructs management to provide notice to the appropriate NCUA regional director, and, in the case of state-chartered credit unions, to their state supervisory authority.
The State of the Financial Services Industry

Finance companies provide lending and financing services to consumers (consumer financing) and to business enterprises (commercial financing). A number of finance companies engage solely in consumer or commercial financing activities; others provide both types. Examples of financial service companies include insurance companies, businesses that provide financing to entice the purchase of goods, and consumer finance companies.

Numerous state and federal statutes affect finance companies’ operations. Some statutes apply only to specific types of activities. Regulations affecting finance companies generally are limited to matters such as loan amounts, repayment terms, interest rates, and collateral; they generally do not address financial accounting and reporting.

Signs of Life From a Credit Crunch Casualty

On May 9, 2008, the Wall Street Journal featured an article that described the current state of securitized debt. Banks and other financial institutions often create securities out of pools of similar loans; for example, mortgages. During the past year these loans have suffered from the credit crisis, as investors lost faith in these debt instruments.

Securitization volumes across all assets classes are still down nearly 80 percent compared to last year and will probably be slow to recover. However, some credit analysts believe that the rationale for certain types of securitized debt, such as loans securitized by subprime loans, remains. Analysts contend that demand for securitized debt backed by auto loans and corporate loans will strengthen. Analysts also believe that debt securitized by complex instruments such as debt obligations that pool together mortgage bonds may remain dormant for a long time.

As discussed previously in this alert, auditors should obtain an understanding of the entity’s objectives and strategies, and the related business risks that may result in material misstatement of the financial statements. This understanding may include the type of debt issued by the financial institution in order to determine if management is taking appropriate measures to prevent unexpected losses in the current environment.

The State of the Mortgage Industry

Weekly Mortgage Bankers Association Survey

On November 5, 2008, the Mortgage Bankers Association’s Weekly Mortgage Application Survey for the week ended October 31, 2008 showed a decrease of 20.3 percent in mortgage loan application volume from the previous week; from 476.7 to 379.9 applications. The refinance index also decreased 27.8 percent compared to the prior week. The survey covers approximately 50 percent of all U.S. retail residential mortgage applications and has been conducted weekly since 1990.

Money Laundering and Trends in Residential Real Estate

On May 1, 2008, the Financial Crimes Enforcement Network (FinCEN) released a report based on an analysis of suspicious activity published by the financial industry that highlights several transactional typologies and associated illicit activities that may be perpetrated by individuals or groups in an attempt to launder funds via residential property transactions.

Included in the report is a study that confirms the increase in money laundering in the financial institutions industry. It is important to note that money laundering by way of real estate transaction is

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1 Practitioners may also find the latest version of the AICPA’s Audit Risk Alert Insurance Companies Industry Developments—2008 (product no. 022359) helpful when auditing financial service companies.

AICPA Audit and Accounting Manual
different than other forms of bank fraud (for example, mortgage fraud) because those seeking to launder money intend to make the required mortgage payments. In fact, making the required payments is necessary for money laundering in order to disguise the source of funds.

.66 Financial institutions in the United States have been able to identify some possible instances of money laundering through residential real estate. The use of real estate to launder money is also well documented internationally. Auditors should be aware of the financial institution’s policies and procedures to assure that proper review and approval of high risk loans are followed. For more information please refer to www.fincen.gov/news_room/.

Legislative and Regulatory Developments

Proposed Interagency Appraisal and Evaluation Guidelines

.67 On November 13, 2008 the federal bank, thrift, and credit union regulatory agencies jointly issued proposed Interagency Appraisal and Evaluation Guidelines that reaffirm supervisory expectations for real estate appraisals and evaluation practices. The proposed guidance is designed to clarify and strengthen an entity’s risk management principals and internal controls to ensure that the entity’s real estate collateral valuations are reliable.

.68 The proposed guidance incorporates recent supervisory issuances and reflects changes in industry practice, including uniform appraisal standards and available technologies. The proposed guidance also addresses

- additional detail on agencies expectations for an independent appraisal and evaluation function;
- greater explanation of the agencies minimal appraisal standards;
- revision to the Uniform Standards of Professional Appraisal Practice; and
- risk focused appraisal and evaluation reviews.

.69 For more information please visit www.ots.treas.gov/?p=PressReleases&ContentRecord_id=9700d0c5-1e0b-8562-e8a2-84c5dcd00a86&ContentType_id=4c12f337-b596-c87-b45c-83895842bf3.

Bank Support for Money Market Mutual Funds

.70 On September 17, 2008, the SEC Office of the Chief Accountant clarified that bank support of money market mutual funds does not normally result in a requirement to report the fund on-balance sheet. Furthermore, the Office of the Chief Accountant believes that on-balance sheet accounting for money market funds is not required if the investing (or sponsoring) financial institution does not absorb the majority of the expected future risk associated with the money market fund’s assets. Should a situation occur where a financial institution is exposed to a majority of expected future risk, consultation on the issues associated with presenting money market mutual funds in the financial statements is encouraged by the Office of the Chief Accountant.


Temporary Guarantee Program for Money Market Funds

.72 On September 29, 2008, the U.S. Department of the Treasury began its temporary guarantee program for money market funds. The program guarantees the share price of any publicly traded money market fund, both retail and institutional. The program is designed to last for three months, after which the secretary of the Treasury will determine if the program should be extended.

.73 In order to participate in the program, eligible money market funds must apply and pay a fee. Money market funds with net asset values per share greater than or equal to $0.9975 as of the close of
business on September 19, 2008 may participate in the program. In order to do so, money market funds must pay 0.01 percent of 1 basis point, based on the number of shares outstanding on that date. Funds with per share values less than $0.9975 but greater than $0.995 are required to pay an upfront fee of 0.015 percent, 1.5 basis points, based on the number of shares outstanding. The fees only cover three months, the initial duration of the program.

The program provides coverage to shareholders for amounts that they held in participating money market funds as of the close of business on September 19, 2008. The guarantee triggers if the share price falls below $0.995.

**Interim Rule Issued to Implement Temporary Liquidity Guarantee Program**

On October 23, 2008 the FDIC approved an interim rule to govern its newly created Temporary Liquidity Guarantee Program (TLGP). The rule is effective immediately.

The TLGP has two components. One guarantees newly issued senior unsecured debt of the participating organizations, within a certain limit, issued between October 14, 2008 and June 30, 2009. For debt that matures after June 30, 2009, the guarantee remains in effect until June 30, 2012. The other provides full coverage for noninterest bearing transaction deposit accounts, regardless of dollar amount until December 31, 2009.

Eligible entities generally include any FDIC insured depository institution, any U.S. bank holding company, financial holding companies, and certain U.S. savings and loan holding companies. The interim rule includes a provision for certain otherwise ineligible holding companies or affiliates that issue debt for the benefit of an insured institution or eligible holding company to apply for inclusion in the program on a case-by-case basis. For more information visit www.fdic.gov/news/news/press/2008/pr08105.html.

**Interim Final Rule on Risk Based Capital**

On September 19, 2008, the Federal Reserve System adopted measures to reduce the liquidity and other strains being experienced by money market mutual funds. As a result, a special lending asset-backed commercial paper (ABCP) facility was created that enables depository institutions and bank holding companies to borrow from the FRB on a nonrecourse basis if they use the loan proceeds to purchase certain types of ABCP from money market mutual funds. Banking organizations that participate in the ABCP lending facility must acquire and hold ABCP on the balance sheet.

To facilitate this lending program, an exemption from leverage and risk based capital rules for ABCP held by a state member bank or bank holding company as a result of participation in the program has also been adopted on an interim basis. The interim rule became effective on September 19, 2008. The interim rule will expire on January 30, 2009 unless extended by the Governors of the Federal Reserve System.

In addition to the information provided in the preceding, the Federal Reserve System Discount Window has released 20 frequently asked questions (FAQs) that describe solutions on how the program will affect money market funds, what funds are eligible for the program, what has to be reported, as well as other items. These FAQs and others can be accessed at www.frbdiscountwindow.org/faqs.cfm?hdrID=14&dttID=75.

**SEC Proposes “Naked” Short Selling Antifraud Rule**

In March 2008, the SEC proposed antifraud Rule 10b-21 under the Securities Exchange Act of 1934, to address failures to deliver securities associated with naked short selling. Although abusive short selling is not defined in federal securities laws, it refers to short selling stock without having stock availability, and intentionally failing to deliver within the three day settlement cycle. The misrepresentation or failure to deliver is considered fraud by the general antifraud statutes of securities laws.
The proposed rule is intended to highlight the liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons who deceive their broker about their ownership of shares and that fail to deliver securities by the settlement date. For more information, please visit www.sec.gov/news/press/2008/2008-204.htm.

Proposed Regulation on Risk Based Lending

On May 8, 2008, the FRB and Federal Trade Commission announced proposed regulations that would require a lending institution to provide a consumer with a risk-based pricing notice when, based in whole or in part on the consumer’s credit report, the creditor offers or provides credit to the consumer on terms less favorable than the terms it offers or provides to other consumers.

Risk-based pricing refers to the practice of using a consumer’s credit report, which reflects his or her risk of nonpayment, in setting or adjusting the price and other terms of credit offered or extended to a particular consumer. Under these rules, a risk-based pricing notice would generally be provided to the consumer after the terms of credit have been set, but before the consumer becomes contractually obligated on the credit transaction.

The proposed regulation provides a number of different approaches that creditors may use to identify the consumers to whom they must provide risk-based pricing notices. In addition, the proposed rule includes certain exceptions to the notice requirement. The most significant of the exceptions permits creditors, in lieu of providing a risk-based pricing notice to those consumers who receive less favorable terms, to provide all of their consumers with their credit scores and explanatory information.

The proposed regulation implements Section 311 of the Fair and Accurate Credit Transactions Act of 2003, which amends the Fair Credit Reporting Act. For more information, visit www.federalreserve.gov/newsevents/press/bcreg/20080508a.htm.

NCUA to Issue Proposed Unfair or Deceptive Credit Practice Rule

On May 2, 2008, the NCUA Board approved a joint proposed rule prohibiting credit card and overdraft service practices as unfair or deceptive under Section 5 of the Federal Trade Commission Act. The proposed rule, issued with the FRB and OTS prohibits the following 7 practices:

1. Unfair time constraints for consumers to make payments
2. Unfair allocations of payments based on balances with different interest rates
3. Unfair application of increased annual percentage rates to outstanding balances
4. Unfair fees for exceeding the credit limit solely because of a hold placed on an account
5. Unfair balance computation method
6. Unfair financing of security deposits and fees for issuance or availability of credit
7. Deceptive firm offers of credit

The rule also requires federal credit unions (FCUs) to provide an opportunity for a consumer to opt out of an overdraft protection program and would prohibit an FCU from charging a fee for an overdraft caused by a hold placed on consumer funds in connection with the use of a debit card.

FDIC Coverage Rules for Revocable Trusts Simplified

On September 26, 2008, the FDIC adopted changes to simplify the rules for determining the amount of coverage available on revocable trust accounts. These accounts are also referred to as payable on death or living trust accounts. The adopted changes, which are effective immediately, eliminate the concept of qualifying beneficiaries, as a result virtually any beneficiary can be named.
Under the revised rules, coverage is based on the number of beneficiaries named in a depositor’s revocable trust account. The insurance limit is still based on $100,000 per named beneficiary. If a revocable trust account owner has more than $500,000 in such accounts, naming more than 5 beneficiaries, the coverage is the greater of either $500,000 or the sum of all the named beneficiaries’ share of interest in the trusts, limited to $100,000 per different beneficiary.

The new rules are effective now and apply to all existing and future revocable trust accounts at FDIC insured institutions. For more information visit the FDIC Web site: www.fdic.gov/news/news/press/2008/pr08086.html.

Foreclosure Prevention Proposal From the OTS

On February 20, 2008, the OTS proposed a plan to help homeowners avoid foreclosure. The homeowners in question are unable to refinance their loan because the fair market value of the property is less than the current outstanding loan amount. The proposal has several objectives, including the following:

- To identify a market driven solution that avoids new government guarantees or assistance
- To ensure that the motivation to “game” the system by borrowers currently able to pay their existing loan is minimized
- To avoid providing a windfall to borrowers and investors in properties held in securitization

Pursuant to the proposal, the Federal Housing Authority (FHA) would issue a new loan to the homeowner based on the fair value of the property. The original loan holder receives negative equity interest in the property equal to the amount of the discount between the new loan and the unpaid balance on the original mortgage. Once the property is sold, any amount greater than the discount payout would be payable to the holder of the negative equity (the owner).

The OTS believes that the proposal offers a market driven solution to the mortgage crisis that does not “bail out” borrowers. They also believe that the negative equity created by the FHA loan could create a marketable financial instrument. For more information, visit the OTS Web site at http://files.ots.gslsolutions.com/481075.pdf.

Illustrations of Consumer Information for Hybrid Adjustable Rate Mortgage Products

On May 29, 2008, the FRB, FDIC, OCC, OTS, and NCUA published Illustrations of Consumer Information for Hybrid Adjustable Rate Mortgage Products, which is intended to assist institutions as they implement the “Consumer Protection Principles” section of the Interagency Statement on Subprime Mortgage Lending (subprime statement). The illustrations present examples of the types of consumer information that the agencies recommend institutions provide. The illustrations are not intended as model forms and institutions will not be required to use them. Some highlights include the following:

- The illustrations are intended to assist institutions in providing consumer information as discussed in the “Consumer Protection Principles” section of the subprime statement.
- A narrative illustration explains some of the key features of certain adjustable rate mortgage (ARM) loans identified in the subprime statement.
- The narrative emphasizes features that borrowers should understand—escrow payments or their absence, prepayment penalties, balloon payments, and premiums for no-document or low-document loans.
- Charts that contain numerical examples are designed to show the potential consequences of payment shock for an ARM loan structured with a reduced initial interest rate.

Bank Secrecy Act

.97 The Bank Secrecy Act of 1970 (BSA, or otherwise known as the Currency and Foreign Transactions Reporting Act) requires U.S. financial institutions to assist U.S. government agencies to detect and prevent money laundering. Specifically, the act requires financial institutions to keep records of cash purchases of negotiable instruments, file reports of cash transactions exceeding $10,000 (daily aggregate amount), and to report suspicious activity that might signify money laundering, tax evasion, or other criminal activities. The act was passed by the U.S. Congress in 1970. The BSA is sometimes referred to as an anti-money laundering law (AML) or jointly as BSA/AML. For more information visit www.fincen.gov/statutes_regs/bsa/.

Amendment to BSA

.98 The BSA was recently amended to implement enhanced due diligence requirements with regard to accounts established or maintained by foreign banks. Title 31 of the U.S. Code of Federal Regulations (CFR) Part 103.176(b) requires banks to establish risk-based due diligence policies, procedures, and internal controls when maintaining or managing a correspondent account in the United States for foreign banks, based on

- an offshore banking license.
- a banking license issued by a foreign country that has been designated as noncooperative with the international AML principles or procedures by an intergovernmental group or organization of which the United States is a member, and with which designation the U.S. representative to the group concurs.
- a banking license issued by a foreign country that has been designated by the secretary of the Treasury as warranting special measures due to money laundering concerns.

.99 In addition to the requirement to establish enhanced due diligence policies, procedures, and controls, the bank must, at a minimum, take reasonable steps to

- determine the identity of each of the owners of foreign banks whose shares are not publicly traded and the nature and extent of the ownership.
- conduct enhanced scrutiny of such accounts to guard against money laundering and to report suspicious activity. The level of enhanced scrutiny is to be based on the bank’s risk assessment of the account. If appropriate, the bank should
  — obtain and review information related to the foreign bank’s AML program and assess the risk of money laundering within or through the foreign bank.
  — monitor transactions to, from, and through the correspondent account in a manner that is reasonably designed to detect money laundering and suspicious activity.
  — obtain information from the foreign bank about the identity of any person with the authority to direct transactions through any correspondent account that is a payable through account, as well as the sources and the beneficial owner of the funds or other assets in the payable through account.
  — determine whether the foreign bank for which the correspondent account is maintained in turn maintains correspondent accounts for other foreign banks that use the bank’s foreign correspondent account. If so, the bank must take reasonable steps to assess and mitigate money laundering risks associated with the foreign bank’s correspondent accounts with other foreign banks, including the identity of those foreign banks as appropriate.

.100 The amendment was published on August 9, 2007 and the rules are to be applied to all correspondent accounts established on or behalf of the foreign banks listed in 31 CFR 103.176(c) on or after February 5, 2008. The enhanced due diligence requirements are retroactive to previously established accounts. For any accounts established prior to February 5, 2008, the bank must have enhanced due diligence policies, procedures and controls in place and applied to all such accounts by May 1, 2008.
Bank Securities Activities

.101 On October 29, 2007, the SEC and FRB jointly issued final rule Regulation R that defines the extent to which brokerage activities of banks are subject to SEC regulations. The SEC and FRB consulted with the OCC, FDIC, and OTS. The final rule is commonly referred to as Regulation R and implements provisions of the Gramm-Leach-Bliley Act of 1999 (GLBA).

.102 Regulation R defines the terms used in several of GLBA's statutory exceptions and includes certain related exemptions. The final rule allows a bank, subject to certain conditions, to continue to conduct securities transactions for patrons as a function of the bank’s trust, fiduciary, custodial, and deposit sweep functions and to refer the patron to a securities dealer pursuant to an existing networking agreement with the broker dealer. The regulation also includes exemptions related to foreign securities transactions, noncustodial securities lending transactions conducted in an agency capacity, and the execution of transactions other than through a broker dealer.

.103 The banking agencies (OTS, FDIC, and OCC) will develop and request public comment on the record keeping rules for banks that operate under broker exceptions as outlined in the Securities Exchange Act of 1934 (Exchange Act). The SEC will act as a consultant during the design of these rules, and will establish record keeping requirements that enable banks to demonstrate compliance with statutory exceptions and any newly finalized rules. The banking agencies are also revisiting the Interagency Statement on Retail Sales of Nondeposit Investment Products to determine the appropriate revisions based on changes implemented by the GLBA.

.104 The effective date of most of Regulation R’s provisions is September 28, 2008. Banks are exempt from complying with the rules and the “broker” exceptions in Section 3(a)(4)(B) of the Exchange Act until the first day of their first fiscal year that commences after September 30, 2008. The compliance date for most national banks will be January 1, 2009.

.105 In addition to Regulation R, the SEC amended and adopted related rules regarding the exemptions from the definitions broker and dealer for certain securities activities conducted by banks. The adoption is made pursuant to Regulation S of the Securities Act of 1933 and allows banks conduct riskless principal transactions with non-U.S. persons. The SEC is also amending the rules governing brokers in order to align these rules with the new bank broker and dealer provisions.

.106 To view the final rule visit www.occ.treas.gov/ftp/bulletin/2007-42.html.

FinCEN Proposal to Amend Currency Transaction Reporting Exemption Regulations

.107 On April 23, 2008, FinCEN proposed regulations that would significantly simplify the requirements for depository institutions to exempt their eligible customers from currency transaction reporting. The proposed rule would amend the BSA regulation allowing depository institutions to exempt certain persons from the requirements to report transactions in currency in excess of $10,000, in accordance with Government Accountability Office recent recommendations. FinCEN also conducted research to determine if the proposed rule was feasible.

.108 Under current BSA regulations, depository institutions may exempt from Currency Transaction Reports (CTRs) requirements

- large reportable transactions in currency made by other depository institutions, government agencies, or those acting with government authority.
- reportable transactions in currency by eligible nonlisted businesses or payroll customers.
FinCEN proposes the following changes be made to the current regulation:

- Depository institutions would no longer be required to file exemption forms, or to annually review customers that are depository institutions, government agencies, or agencies action on behalf of the government.
- Biannual review of the exempt person designation or other phase II customers would no longer be required.
- Depository institutions would no longer have to wait 12 months before designating otherwise eligible phase II customers by exemption.

FinCEN proposed rule changes to the BSA are designed to increase the effectiveness and efficiency of BSA regulations while maintaining the usefulness of BSA reports (such as CTRs) to law enforcement. For more information please visit www.fincen.gov/news_room/nr/html/20080423.html.

Managing Commercial Real Estate Concentrations in a Challenging Environment

The FDIC is increasingly concerned that institutions with concentrated commercial real estate (CRE) exposures may be vulnerable to a sustained downturn in real estate and should ensure that capital and allowance for lease and loan losses (ALLL) levels are strong, and that credit risk management is robust. As market conditions warrant, institutions with significant CRE concentrations should increase capital that provides protection from unexpected losses if market conditions deteriorate further. The FDIC issued Federal Institutions Letter (FIL) 22-2008, Managing Commercial Real Estate Concentrations in a Challenging Environment, in an attempt to reemphasize the importance of strong capital and loan loss allowances for nonmember institutions with significant CRE and construction and development (C&D) concentrations.

Institutions with significant CRE concentrations should maintain capital and ALLL levels, as well as maintain an overall credit risk process that reflects the principles of 2006 CRE guidance. The FDIC recommends five risk management processes to help institutions with significant C&D and CRE concentrations:

1. Increase strong capital levels. Due to stressed markets, strong capital levels have been called upon to provide protection against unexpected losses. Institutions with significant CRE and C&D exposure may require more capital because market uncertainty has increased the level of unexpected losses. Management and directors should take steps to increase capital levels to support significant CRE and C&D concentrations.

2. Ensure that loan loss allowances are appropriate. As required by GAAP, financial institutions should use their best judgment when determining their ALLL. Institutions should review the collectability of CRE loans and all other exposures in order to determine if their ALLL is a level that could cover estimated credit losses on individual loans that become impaired.

3. Manage C&D and CRE loan portfolios closely. It is vitally important for institutions to maintain prudent, time-tested lending policies during current market conditions.

4. Maintain updated financial and analytical information. Recent borrower financial statements, including property cash flow statements, rent rolls, guarantor personal statements, tax return data, global builder and other income performance measures should be maintained by institutions that have significant CRE concentrations. Management should consider if appraisals conducted during high growth periods are reliable during periods of uncertain market changes. All appraisals should be consistent with the FDIC’s appraisal rules in Part 323 of the FDIC’s Rules and Regulations (Title 12 CFR Part 323).

5. Bolster loan infrastructure. Institutions should maintain adequate staff with the necessary skill set to properly manage an increase in problem loans and workouts. The institution should have a network of legal, underwriting, appraisal, and real estate brokerage professionals to handle relevant issues.
FDIC examiners recognize the challenges faced by many financial institutions in the current CRE environment and expect each institution’s board of directors and management team to maintain robust credit risk policies. Institutions should also strive for strong capital and loan loss allowance levels.

Auditors should note management’s general attitude toward CRE lending policies when considering an institution’s internal controls. Strong CRE lending policies and diligent oversight could assist the auditor when assessing control risk.

**Guidance on Other Real Estate**

On July 1, 2008, the FDIC issued FIL 62-2008, *Guidance on Other Real Estate*, in order to address the current housing market, the rapid rise in foreclosures, and the increased probability of other real estate (ORE) held by FDIC-supervised institutions.

The FDIC encourages FDIC-supervised institutions to avoid unnecessary foreclosures of properties through loan modifications that achieve affordable, sustainable mortgage obligations. Due to the risk of foreclosure, these institutions should maintain established policies and procedures for acquiring, holding, and disposing of ORE. ORE guidance

- details the importance of expenses associated with maintaining and protecting ORE from further deterioration.
- addresses the need to comply with requirements for obtaining initial and updated values for ORE.
- summarizes the accounting and reporting standards for ORE in each phase of ownership; acquisition, holding period, and disposition.


**Housing Stabilization Measures**

On May 12, 2008, the U.S. House of Representatives passed a substantial housing assistance package that would help struggling homeowners avoid foreclosure and ease the growing burden of vacant housing on cities and states. Two bills were passed, the Neighborhood Stabilization Act and the American Housing Rescue and Foreclosure Prevention Act.

**The Neighborhood Stabilization Act**

The Neighborhood Stabilization Act authorizes a 1 year, $7.5 million grant program and a $7.5 billion federal loan program to help sustain neighborhoods and communities experiencing the highest rates of home foreclosure. Funding could be used to rehabilitate houses not up to local codes, to make energy efficiency improvements, and to purchase qualified houses made vacant by foreclosure. Funding could also be used to renovate the houses for rent or resale to income targeted families.

In addition, grant recipients could use up to 8 percent of their grant to cover operating costs such as management fees, taxes, insurance, and other administrative fees associated with the property. The bill gives the Department of Housing and Urban Development the ability to approve funds for the demolition of houses too damaged for rehabilitation. Funds are barred from use for the demolition of public housing.

**The American Housing Rescue and Foreclosure Prevention Act**

The American Housing Rescue and Foreclosure Prevention Act is designed to stimulate foreclosure prevention efforts undertaken by private lenders and mortgage servicers, provide increased liquidity in the mortgage markets, and increase federal regulation and oversight of the lending industry.
Under this bill, the FHA would encourage lenders to voluntarily forgive a portion of outstanding debt on troubled mortgages. In exchange for forgiving the debt, those mortgages would be refinanced into conventional, lower interest mortgages guaranteed by the FHA.

To qualify for the program, lenders would have to accept a payment of no more than 85 percent of the current appraised value of the property as payment in full on the loan. Homeowners would be eligible only if they could reasonably be expected to repay the refinanced loan. They would also have to share any profit from future home appreciation with the government.

Another provision of the bill establishes a federal affordable housing fund paid for by Fannie Mae and Freddie Mac, which would contribute funding equal to 1.2 percent of their total outstanding mortgages. Only very low income families would be eligible for assistance from this fund.

Lastly, the bill provides a legal safe harbor for mortgage loan servicers making certain loan modifications. The provision responds to concerns that mortgage loan servicers are being discouraged from modifying loan terms to prevent foreclosures by the fear of potential lawsuits from investors who stand to lose profits due to loan modification.

Updated Continuity Planning Booklet

On March 19, 2008, the Federal Financial Institutions Examination Council released an updated business continuity planning booklet. The booklet provides guidance to bank examiners, financial institutions, and technology service providers to identify business continuity risks. The booklet provides guidance on the evaluation of internal controls and risk management practices for effective continuity planning. Also included in the booklet is the addition of enhancements to business analysis and testing discussions based on emerging threats and lessons learned in recent years. Lastly, the booklet stresses the responsibilities of management and the institution’s board of directors to address business continuity planning by considering technology, business operations, and testing strategies for the institution.

FDIC Proposes Changes for FDICIA Institutions

On November 2, 2007, the FDIC issued a proposal to amend its regulations that address audit and reporting requirements, internal control assessments, and audit committees. The proposal amends Title 12 Part 363, Annual Independent Audits and Reporting Requirements, of the FDIC Rules and Regulations, which is the FDIC’s implementing regulation of Section 36 of the Federal Deposit Insurance Act. Section 36 was added by the Federal Deposit Insurance Corporation Improvement Act of 1991.

For institutions above certain thresholds, Part 363 generally addresses annual independent audits, internal control over financial reporting assessments, compliance with designated laws and regulations, the establishment of independent audit committees, and related reporting requirements. The asset-size threshold for internal control assessments is $1 billion and the threshold for the other requirements is $500 million, measured as of the beginning of the fiscal year. Of the 8,600 FDIC-insured institutions, approximately 1,300 have $500 million or more in assets while approximately 650 have $1 billion or more in assets.

Also included in Part 363 is appendix A, Guidelines and Interpretations, which is intended to assist institutions and independent public accountants in understanding and complying with Section 36 and Part 363. A new subsection of Part 363 featuring the guideline requirements has been added based on several of the proposed changes.

Some of the more significant revisions include the following:

- Audit committees and auditors
  - Specifies that the audit committee’s duties include the appointment, compensation, and oversight of the external auditor.
— Requires the audit committee to ensure the external audit engagement letter does not contain unsafe and unsound limitation of liability provisions.

— Requires institutions to file copies of the external audit engagement letter with the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor within 15 days of acceptance by the institution.

— Requires the board of directors to adopt written criteria for evaluating an audit committee member’s independence and provide expanded guidance for boards of directors to use in determining independence.

— Clarifies that the external auditor must comply with the Public Company Accounting Oversight Board (PCAOB) independence standards and interpretations in addition to the independence standards and interpretations of the AICPA and the SEC.

— Requires certain communications by the external auditor to the audit committee consistent with the requirements for public companies. These required communications include critical accounting policies, alternative accounting treatments discussed with management, and written communications provided to management (for example, management letters and a schedule of unadjusted differences).

— Establishes retention requirements for external auditor working papers consistent with the seven-year retention period applicable to public companies.

• Management

— Extends the time period for a nonpublic institution to file its Part 363 annual report by 30 days. The reports will now be due 120 days after the end of the fiscal year.

— Permits the use of a 30-day late filing notification if an institution is confronted with extraordinary circumstances.

— Requires management to state its conclusion regarding compliance with designated safety and soundness laws and regulations and disclose any noncompliance with such laws.

— Provides illustrative management reports for the statement of management’s responsibilities, management’s assessment of compliance with laws and regulations, and management’s internal control assessment.

— Requires management and the external auditor to identify the internal control framework used to evaluate internal control.

— Requires management and the external auditor to disclose all material weaknesses.

— Provides relief from reporting on internal control for businesses acquired during the year.


Credit Industry Legislation

Credit Card Company Practices

The Associated Press reported that legislation to rein in the billing and marketing practices of credit card companies is gaining traction in Congress. A bill introduced on April 30, 2008 would require credit card issuers to give account holders 45 days notice of any increase in interest rates. A similar bill is pending the House of Representatives. Both bills are supported by consumer advocacy groups and those who oppose the banking industry. In addition to the bills, the FDR, OTS, and NCUA have also proposed similar curbs to credit card practices.
Credit Union Legislation Introduced Into the Senate

On May 1, 2008, Senator Joe Lieberman introduced the Credit Union Regulatory Improvements Act in the U.S. Senate. This bill allows, among other things, nontraditional credit unions to offer multimillion dollar tax subsidized commercial loans. For more information, visit http://thomas.loc.gov/cgi-bin/ bdquery/z?d110:s.02957:.

Basel II Update

On November 1, 2007, the OCC approved a final rule implementing the advanced approaches as stated in the Basel II Capital Accord. The final rule establishes regulatory and supervisory standards for credit risk through the use of an internal ratings based approach. The final rule also measures operational risk through the use of an advanced measurement approach. Standards for the review of capital adequacy and public disclosure for the largest U.S. banks are also articulated in the final rule.

FDIC Approves Basel II—Based Standardized Approach Capital Proposal

On June 26, 2008, the Board of Directors of the FDIC approved an interagency proposal that would provide banks with the option to adopt an alternative risk-based capital framework based largely upon the standardized approach set forth in the Basel II Framework. The standardized approach is expected to add greater risk sensitivity without creating burdensome complexity and should help minimize competitive inequalities between large and small financial institutions. It is also expected that the standardized approach should provide bank supervisors with some control over unconstrained reductions in risk-based capital.

This approach would be available to all banks except the largest and most complex banks that are subject to the advanced approaches final rules that were issued on December 7, 2007.

Some of the key aspects of the proposal include the following:
- Adding more risk buckets to the existing rules
- Expanding the use of external ratings to a broader range of exposures
- Expanding the recognition of credit risk mitigants, such as collateral and guarantees
- Establishing a more risk-sensitive approach for residential mortgages based largely on loan-to-value measures
- Increasing the capital requirements on certain off-balance sheet exposures, including liquidity lines to asset-backed commercial paper exposures
- Requiring a capital charge for operational risk using the basic indicator approach under the Basel II capital framework

Currently, the agencies are seeking comment on various aspects of the proposed framework. This includes possible changes and alternatives that include the use of external credit ratings, especially for structured finance exposures. Readers of this alert are advised to monitor the progress of this proposed rule at the FDIC Web site.

Audit and Attestation Issues and Developments

Auditing Fair Value Measurements

It is management’s responsibility to determine and disclose an entity’s fair value measurements. When auditing these fair values to ensure conformity with GAAP, auditors should consult AU section 328, Auditing Fair Value Measurements and Disclosures (AICPA, Professional Standards, vol. 1), which establishes standards and provides guidance for auditors. Specific types of fair value measurements are not covered by AU section 328.
328. For example, when auditing the fair value of derivatives and securities, refer to AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, Professional Standards, vol. 1).

.140 The strongest audit evidence to support a fair value is an observable market price in an active market. If that is not available, a valuation method should incorporate common market assumptions. If common market assumptions are not available or require significant adjustments, the entity may use its own assumptions. The auditor should obtain an understanding of the entity’s process for determining fair values, as well as whether the fair value measurements and disclosures are in accordance with GAAP. During this testing, the auditor may also identify possible indicators of impairment. According to paragraph .23 of AU section 328, “substantive tests of the fair value measurements may involve (a) testing management’s significant assumptions, the valuation model, and the underlying data, (b) developing independent fair value estimates for corroborative purposes, or (c) reviewing subsequent events and transactions.”

.141 According to paragraph .48 of AU section 328, the auditor ordinarily should add language to the letter of representations from management regarding the reasonableness of significant underlying assumptions. When significant assumptions are used or they are highly subjective and the items being measured at fair value are material, the auditor should consider discussing these items with those charged with governance of the entity.

**Fair Values of Securities**

.142 The guidance in AU section 332 relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, there are some items of note for the auditor. As noted previously, quoted market prices in active markets are the best available audit evidence to support a fair value. However, when they are unavailable and the valuations of securities are obtained from a broker-dealer or another third party source based on valuation models, the auditor should understand the underlying valuation method used (such as a cash flow projection). The auditor may also determine that it is necessary to obtain quotes from more than one pricing source based on circumstances such as an existing relationship between the entity and the valuing entity, which could inhibit objective pricing or underlying valuation assumptions that are highly subjective. In the context of FASB Statement No. 157 quoted prices in active markets are considered level 1 inputs.

.143 When an entity performs its own valuation, value testing procedures to be taken by the auditor include assessing the reasonableness and appropriateness of the model, calculating the value using his or her own model, and comparing the fair value with subsequent or recent transactions. Whether the inputs to the entities’ valuation model are observable or not determines their characterization as level 2 or level 3 inputs, respectively, within FASB Statement No. 157. When there is extensive judgment, consider using a specialist or refer to AU section 342, *Auditing Accounting Estimates* (AICPA, Professional Standards, vol. 1). Additionally, when the underlying collateral of a security significantly contributes to its fair value and collectability of the security, evidence of the collateral should also be examined for existence, fair value, transferability, and the investor’s right to the collateral.

.144 The auditor should also evaluate management’s conclusions regarding other than temporary impairment on its securities. Examples of factors that could cause an *other than temporary impairment* per paragraph .47 of AU section 332 include the following:

- Fair value is significantly below cost and—
  - The decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
  - The decline has existed for an extended period of time.
  - Management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
- The security has been downgraded by a rating agency.
• The financial condition of the issuer has deteriorated.
• Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
• The entity recorded losses from the security subsequent to the end of the reporting period.

.145 Additional factors to consider when determining whether a security is other than temporarily impaired, as described in the September 30, 2008 press release on clarifications on fair value accounting (SEC and FASB press release), by the SEC Office of the Chief Accountant and FASB staff, include “length of time and the extent to which the market value has been less than cost; the financial condition of the issuer; and ... the intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.” The classification of an entity’s securities is based on management’s intent and ability. The auditor should obtain an understanding of management’s classification process between trading, available-for-sale, or held-to maturity, as well as consider the classifications in light of the entity’s current financial position.

Liquidity Restrictions

.146 As mentioned in “The State of the Economy” section of this alert, unprecedented events occurred in the financial markets in September 2008 resulting in Congress appropriating up to $700 billion to purchase various asset-backed securities. Generally, many fixed income markets became extraordinarily illiquid in late September 2008, resulting in a substantial increase in risk over the valuation assertion for virtually any kind of fixed income security of any duration. There also were concerns about the possibility of significant redemptions from various types of funds, and some reports of certain private funds either placing limits on redemptions, freezing the ability to redeem entirely, or determining to commence an orderly wind-down of operations. Thus, subsequent events reporting considerations and assessment of the going concern status of some entities take on added importance in the current environment.

.147 AICPA staff has issued a nonauthoritative TIS section 1100.15 addressing the potential accounting and auditing implications when a fund or its trustee imposes restrictions on a nongovernmental entity’s ability to withdraw its balance in a money market fund or other short term investment vehicle. The TPA covers balance sheet classification, disclosures, debt covenants, subsequent events, and going concern considerations, among other things. The TPA can be found at www.aicpa.org/download/acctstd/TIS1100_15.pdf.

Consideration of an Entity’s Ability to Continue as a Going Concern

.148 The consideration of an entity’s ability to continue as a going concern is required in every audit performed under generally accepted auditing standards (GAAS) and is an especially important consideration in the current state of the residential market and the overall economy. It is important to note the time frame for this consideration is one year beyond the date of the financial statements. If the auditor believes there is a substantial doubt on the entity’s ability to continue as a going concern, the next steps are to obtain management’s plans to mitigate the effect of such conditions and then assess the likelihood these plans can be effectively implemented.

.149 If an auditor determines there is a substantial doubt about an entity’s ability to continue as a going concern, the auditor should communicate with those charged with governance of the entity in accordance with AU section 341, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern (AICPA, Professional Standards, vol. 1). AU section 341 provides guidance to an auditor with respect to evaluating whether there is substantial doubt about an entity’s ability to continue as a going concern and what the auditor should do when a going concern exists.

Consideration of Fraud

.150 Auditors should consider the pressures financial institutions are facing when planning and performing the audit engagement. Auditors have a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Paragraph .32 of AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), explains that when obtaining information about the entity and its
environment, an auditor should consider whether the information indicates that one or more fraud risk factors are present. The auditor should use professional judgment in determining whether a risk factor is present and should be considered in identifying and assessing the risks of material misstatement due to fraud. Paragraph .33 of AU section 316 lists three conditions generally present when fraud exists: incentive or pressure to perpetrate fraud, an opportunity to carry out the fraud, and attitude or rationalization to justify the fraudulent action.

**Allowance for Lease and Loan Losses**

.151 The ALLL represents one of the most significant estimates in a financial institution’s financial statements and regulatory reports. Each institution has a responsibility for developing, maintaining, and documenting a comprehensive, systematic process for determining the amounts of ALLL and the provision for loan and lease losses (PLL). Loans and leases should be reviewed, at least, quarterly to determine if the ALLL amount is able to cover the estimated credit losses on individually evaluated loans that are determined to be impaired as well as estimated credit losses inherent in the remainder of the loan and lease portfolio.

.152 When estimating credit losses, consideration should be given to several significant factors that affect the collectability of the portfolio as of the evaluation date. The historical loss experience provides a reasonable starting point for the institution’s analysis, historical losses, or even recent trends in losses, but do not by alone form a sufficient basis to determine the appropriate level for the ALLL. Management should also consider those qualitative or environmental factors that are likely to cause estimated credit losses associated with the institution’s existing portfolio to differ from historical loss experience. Qualitative changes include changes in internal loan policy, the nature and volume of similar loans, a change in the ability and depth of management, and legal and regulatory requirements.

.153 The principal sources of guidance on accounting for impairment in a loan portfolio under GAAP are FASB Statement No. 5, *Accounting for Contingencies*, and FASB Statement No. 114, *Accounting for Creditors for Impairment of a Loan—an amendment of FASB Statements No. 5 and 15*. Additionally, EITF Topic No. D-80, “Application of FASB Statement No. 5 and No. 114 to a Loan Portfolio,” presents questions and answers that provide specific guidance on the interaction between these two FASB statements and may be helpful when applying them.

.154 According to paragraph .56 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), the risk of material misstatement of the financial statements is generally greater when account balances and classes of transactions are subject to estimation rather than precise measurement because of the inherent subjectivity in estimating future events. Auditors should consider the guidance in AU section 312 when examining a financial institution’s ALLL.

**Responsibilities of Management and Those Charged With Governance**

.155 Each financial institution’s management is responsible for maintaining the ALLL at an appropriate level. Management should document its analysis according to the standards set forth in the 2006 Federal Financial Institutions Examination Council Revised Policy Statement. Management’s analysis and evaluation is subject to review by examiners. Failure to maintain and support ALLL in accordance with GAAP and supervisory guidance is not considered sound practice. At a minimum, the institution’s policies and procedures should include

- a well documented comprehensive process for determining the ALLL level.
- an effective loan review system with internal controls that include monitoring and correct loan classification.
- adequate data capture and reporting systems to supply information necessary to support its estimate of ALLL.
- available information to confirm that a loan or lease determined to be uncollectable.
• documentation to support evaluation of any loss estimation models before they are employed by the financial institution.

.156 Those charged with governance in the financial institution are responsible for overseeing management’s significant judgments and estimates concerning ALLL. Generally, this oversight includes, but is not limited to, the following:

• Review and approval of management’s ALLL policies and procedures, at least annually
• Review of management’s assessment and justification of loan review system based on the institution’s size and complexity
• Management’s assessment and justification of estimated ALLL and PLLL amounts reported each period
• Management’s periodic validation and revision of ALLL policies

Auditing the ALLL

.157 AU section 342 paragraph .03 states that management is responsible for making the accounting estimates included in the financial statements. Estimates are based on subjective as well as objective factors and, as a result, judgment is required to estimate an amount at the date of the financial statements. Management’s judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take. According to AU section 342 paragraph .04, the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole. As estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them.

.158 AU section 342 provides guidance on auditing accounting estimates (such as estimates of fair values, discussed previously, and estimates of loan losses). AU section 342 discusses how an auditor obtains an understanding of how management developed estimates, concentrating on the key factors and assumptions used. It also discusses how the auditor evaluates the reasonableness of those estimates. AU section 328 establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements.

.159 The auditor typically achieves objectives for auditing the allowances by testing management’s estimates of the allowance based on available and relevant information regarding loan collectability. The auditor is not responsible for estimating the amount of the allowance or ascertaining the collectability of each, or any, specific loan included in an institution’s loan portfolio. However, the auditor’s primary objective of audit procedures for credit losses is to obtain reasonable assurance surrounding the loan loss estimate. Some questions include the following:

• Are the allowance for loan losses and the allowance for credit losses on off-balance sheet credit exposures reasonably estimated in accordance with GAAP to cover the amount of probable credit losses inherent in the loan portfolio and in off-balance sheet financial instruments, respectively, at the balance-sheet date?
• Are internal controls over the allowance estimation process operating effectively?
• Is the allowance calculation properly documented and in accordance with current accounting and regulatory guidance?
• Are disclosures adequate?
• Is the allowance excessive or does it imply shortfall?
• Is there directional consistency between credit quality indicators (for example, charge-offs versus delinquencies, and loan-loss provision levels versus allowance levels)?
Summary of Recent Auditing and Attestation Pronouncements and Related Guidance

.160 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. This alert is intended to be used in conjunction with Comprehensive Audit Risk Alert—2008 (product no. 022339kk); therefore, only industry specific pronouncements and related guidance or those of specific significance to the industry are summarized herein. For information on auditing and attestation standards issued subsequent to the writing of this alert, please refer to the AICPA Accounting and Auditing Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the CPA Letter, Journal of Accountancy, and in the quarterly electronic newsletter In Our Opinion, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

.161 The PCAOB establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review Audit Risk Alert SEC and PCAOB Developments—2008 (product no. 022499kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by visiting www.cpa2biz.com.

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<tr>
<th>Recent Auditing and Attestation Pronouncements and Related Guidance</th>
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<tr>
<td><strong>Statement on Auditing Standards (SAS)</strong> No. 115, Communicating Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, vol. 1, AU sec. 325) Issue Date: October 2008 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS]) <strong>SAS No. 114, The Auditor’s Communication With Those Charged With Governance</strong> (AICPA, Professional Standards, vol. 1, AU sec. 380) Issue Date: December 2006 (Applicable to audits conducted in accordance with GAAS)</td>
</tr>
<tr>
<td>Replacing SAS No. 112, Communicating Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, vol. 1, AU sec. 325A), this standard defines the terms deficiency in internal control, significant deficiency, and material weakness; provides guidance on evaluating the severity of deficiencies in internal control identified in an audit of financial statements; and requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit. It is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.</td>
</tr>
<tr>
<td>Replacing SAS No. 61, Communication With Audit Committees, this standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, to whom they should be communicated, and the form and timing of the communication. It is effective for audits of financial statements for periods beginning on or after December 15, 2006.</td>
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(continued)
**Recent Auditing and Attestation Pronouncements and Related Guidance**

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<thead>
<tr>
<th>Pronouncement</th>
<th>Description</th>
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| **SAS No. 113, Omnibus Statement on Auditing Standards—2006 (AICPA, Professional Standards, vol. 1)** | This standard does the following:  
- Revises the terminology used in the 10 standards of AU section 150, Generally Accepted Auditing Standards, to reflect terminology in AU section 120, Defining Professional Requirements in Statements on Auditing Standards (AICPA, Professional Standards, vol. 1).  
- Adds a footnote to the headings before paragraphs .35 and .46 in AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), to provide a clear link between the auditor’s consideration of fraud and the auditor’s assessment of risk and the auditor’s procedures in response to those assessed risks.  
- Replaces throughout the SASs the term completion of fieldwork with the term date of the auditor’s report.  
- Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor’s report. |

| Issue Date: November 2006 | (Applicable to audits conducted in accordance with GAAS) |

| SAS Nos. 104–111, the risk assessment standards | The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits; focusing on identifying and assessing the risks of material misstatements; further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels; and improving the linkage between the risks, controls, audit procedures, and conclusions. These eight SASs became effective for audits of financial statements for periods beginning on or after December 15, 2006. |

| Issue Date: March 2006 | (Applicable to audits conducted in accordance with GAAS) |

| Statement on Standards for Attestation Engagements (SSAE) No. 15, An Examination of an Entity’s Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements (AICPA, Professional Standards, vol. 1, AT sec. 501) | This statement establishes requirements and provides guidance that applies when a practitioner is engaged to perform an examination of the design and operating effectiveness of an entity’s internal control over financial reporting (examination of internal control) that is integrated with an audit of financial statements (integrated audit). This SSAE is effective for integrated audits for periods ending on or after December 15, 2008. Earlier implementation is permitted. |

| Issue Date: October 2008 | |

| SSAE No. 14, SSAE Hierarchy (AICPA, Professional Standards, vol. 1, AT sec. 50) | This standard identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in AT section 20, Defining Professional Requirements in Statements on Standards for Attestation Engagements (AICPA, Professional Standards, vol. 1). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006. |

<p>| Issue Date: November 2006 | |</p>
<table>
<thead>
<tr>
<th>Interpretation</th>
<th>Description</th>
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<tbody>
<tr>
<td>No. 19, “Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board,” of AU section 508 (AICPA, <em>Professional Standards</em>, vol. 1, AU sec. 9508 par. .93–.97)</td>
<td>This interpretation of AU section 508 addresses the application of AU section 508 in reporting on financial statements prepared in conformity with IFRS. Issue Date: May 2008</td>
</tr>
</tbody>
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(continued)
### Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th><strong>Statement of Position (SOP) 07-2,</strong> Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisers, or Other Service Providers (AICPA, Technical Practice Aids, AUD sec. 14.430)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue Date: October 2007</td>
</tr>
<tr>
<td>(Interpretive publication)</td>
</tr>
<tr>
<td><strong>This statement addresses the application of SSAEs primarily to examination engagements in which a practitioner reports on the suitability of the design and operating effectiveness of a service provider’s controls in achieving specified compliance control objectives. Examples of the service providers addressed by this SOP are investment advisers, custodians, transfer agents, administrators, and principal underwriters that provide services to investment companies, investment advisers, or other service providers.</strong></td>
</tr>
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<tr>
<th><strong>AICPA Technical Practice Aid (TPA) Technical Questions and Answers (TIS) section 1100.15, “Liquidity Restrictions” (AICPA, Technical Practice Aids)</strong></th>
</tr>
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<tbody>
<tr>
<td>Issue Date: October 2008</td>
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<tr>
<td>(Nonauthoritative)</td>
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<tr>
<td><strong>This question and answer discusses auditing and accounting issues related to withdrawal restrictions placed on short term investments by a money market fund or its trustee.</strong></td>
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<tr>
<th><strong>TIS sections 8200.05–.16 (AICPA, Technical Practice Aids)</strong></th>
</tr>
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<tbody>
<tr>
<td>Issue Date: April and May 2008</td>
</tr>
<tr>
<td>(Nonauthoritative)</td>
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<tr>
<td><strong>These questions and answers in TIS section 8200, Internal Control, were developed in response to common questions received from members regarding the implementation of SAS Nos. 104–111. Some of the topics include</strong></td>
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<tr>
<td>• consideration of internal controls that are less formal or not documented by the client.</td>
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<td>• whether the auditor may suggest improvements to a client’s internal control.</td>
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<td>• assessing inherent risk in relation to the consideration of control risk.</td>
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<td>• the frequency of walkthroughs that are used as the basis for the auditor’s understanding of internal control.</td>
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<td>• considerations in obtaining an understanding of, evaluating, and documenting controls that the auditor believes are nonexistent or ineffective.</td>
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<td>• assessing control risk at the maximum level.</td>
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<td>• considerations for developing a substantive audit strategy.**</td>
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<tr>
<th><strong>TIS section 9120.08, “Part of an Audit Performed in Accordance With International Standards on Auditing” (AICPA, Technical Practice Aids)</strong></th>
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<tbody>
<tr>
<td>Issue Date: April 2008</td>
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<tr>
<td>(Nonauthoritative)</td>
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<tr>
<td><strong>This question and answer discusses the implications to the principal auditor’s report when part of an audit is conducted by other independent auditors in accordance with International Standards on Auditing or another country’s auditing standards.</strong></td>
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## Recent Auditing and Attestation Pronouncements and Related Guidance

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<tr>
<th>Reference</th>
<th>Description</th>
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<tbody>
<tr>
<td>TIS section 9100.06, “The Effect of Obtaining the Management Representation Letter on Dating the Auditor’s Report” (AICPA, Technical Practice Aids)</td>
<td>This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor’s report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor’s report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that it will sign the representation letter, without exception, on or before the date of the representations.</td>
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<tr>
<td>Issue Date: May 2007</td>
<td></td>
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<tr>
<td>(Nonauthoritative)</td>
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<tr>
<td>TIS section 8350.01, “Current Year Audit Documentation Contained in the Permanent File” (AICPA, Technical Practice Aids)</td>
<td>This question and answer discusses whether the provisions of AU section 339, Audit Documentation (AICPA, Professional Standards, vol. 1), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that AU section 339 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year’s audit report.</td>
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<tr>
<td>Issue Date: May 2007</td>
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<tr>
<td>(Nonauthoritative)</td>
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<tr>
<td>AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, Audit Confirmations (AICPA, Technical Practice Aids, PA sec. 16,240)</td>
<td>This practice alert is a response to practitioners’ current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics.</td>
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<tr>
<td>Revised: June 2007</td>
<td></td>
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<tr>
<td>(Nonauthoritative)</td>
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<tr>
<td>AICPA PITF PA 07-1, Dating of the Auditor’s Report and Related Practical Guidance (AICPA, Technical Practice Aids, PA sec. 16,290)</td>
<td>This practice alert provides guidance regarding application of certain provisions of AU section 339, primarily related to dating the auditor’s report.</td>
</tr>
<tr>
<td>Issue Date: January 2007</td>
<td></td>
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<tr>
<td>(Nonauthoritative)</td>
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<tr>
<td>Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 6, Evaluating Consistency of Financial Statements (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)</td>
<td>This standard and its related amendments update the auditor’s responsibilities to evaluate and report on the consistency of a company’s financial statements and align the auditor’s responsibilities with Financial Accounting Standards Board (FASB) Statement No. 154, Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3. This standard also improves the auditor reporting requirements by clarifying that the auditor’s report should indicate whether an adjustment to previously issued financial statements results from a change in accounting principles or the correction of a misstatement.</td>
</tr>
<tr>
<td>Issue Date: November 15, 2008</td>
<td></td>
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<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
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### Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
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<tr>
<th>PCAOB Auditing Standard No. 5, <em>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</em> (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)</th>
<th>This standard replaces the PCAOB’s previous internal control standard, Auditing Standard No. 2, <em>An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements</em>. This principles-based auditing standard is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company’s financial statements, and, at the same time, eliminate procedures that are unnecessary. Auditing Standard No. 5 is required to be used by registered audit firms for all audits of internal control over financial reporting no later than for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted and encouraged.</th>
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<tr>
<td>Issue Date: July 2007</td>
<td></td>
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<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
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<tr>
<th>PCAOB Rule 3526, <em>Communication with Audit Committees Concerning Independence</em> (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”)</th>
<th>Rule 3526 requires the registered public accounting firm to</th>
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<tr>
<td>Issue Date: August 2008</td>
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<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
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<td></td>
<td>• describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence;</td>
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<td></td>
<td>• discuss with the audit committee of the issuer the potential effects of any relationships that could impact independence, should they be appointed as the issuer’s auditor; and</td>
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<td>• document the substance of these discussions. These discussions should occur at least annually.</td>
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<td></td>
<td>The board also adjusted the implementation schedule for Rule 3523, <em>Tax Services for Persons in Financial Reporting Oversight Roles</em> (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”), as it applies to tax services. The board agreed not to apply Rule 3523 to tax services provided on or before December 31, 2008 when those services are provided during the audit period and are completed before the professional engagement period begins. The amendments to Rule 3523 became effective August 28, 2008. The remaining provisions of Rule 3526 became effective on September 30, 2008.</td>
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Recent Auditing and Attestation Pronouncements and Related Guidance

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<tr>
<th>PCAOB Rule 3525, Audit Committee Preapproval of Non-audit Services Related to Internal Control Over Financial Reporting (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”)</th>
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<tbody>
<tr>
<td><strong>Issue Date:</strong> July 2007</td>
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<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
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<tr>
<td>This rule requires a registered public accounting firm that seeks preapproval of an issuer audit client’s audit committee to perform internal control-related nonaudit services that are not otherwise prohibited by the act or the rules of the Securities and Exchange Commission (SEC) or the PCAOB to describe, in writing, to the audit committee the scope of the proposed service, discuss with the audit committee the potential effects of the proposed service on the firm’s independence, and document the substance of the firm’s discussion with the audit committee. These requirements parallel the auditor’s responsibility in seeking audit committee preapproval to perform tax services for an audit client under PCAOB Rule 3524, Audit Committee Pre-approval of Certain Tax Services (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”). This rule is effective for audits of fiscal years ending on or after November 15, 2007.</td>
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<tr>
<th>PCAOB Conforming Amendments to the Interim Auditing Standards (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)</th>
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<tr>
<td><strong>Issue Date:</strong> November 15, 2008</td>
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<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
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<tr>
<td>In conjunction with the PCAOB’s adoption of Auditing Standard No. 6, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in appendix 2 of PCAOB Release No. 2008-001 at <a href="http://www.pcaob.org/Rules/Docket_023/PCAOB_Release_No_2008-001_-_Evaluating_Consistency.pdf">www.pcaob.org/Rules/Docket_023/PCAOB_Release_No_2008-001_-_Evaluating_Consistency.pdf</a>.</td>
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<th>PCAOB Conforming Amendments to the Interim Auditing Standards (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)</th>
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<tbody>
<tr>
<td><strong>Issue Date:</strong> July 2007</td>
</tr>
<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
</tr>
<tr>
<td>In conjunction with the PCAOB’s adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in appendix 3 of PCAOB Release No. 2007-005A at <a href="http://www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf">www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf</a>. These amendments are effective for audits of fiscal years ending on or after November 15, 2007, the same effective date of Auditing Standard No. 5.</td>
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<tr>
<td><strong>Issue Date:</strong> January 2007</td>
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<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
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<tr>
<td>This release focuses on aspects of the PCAOB’s interim auditing standards that address the auditor’s responsibility with respect to fraud, specifically AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, PCAOB Standards and Related Rules). This report does not change or propose to change any existing standard nor is the PCAOB providing any new interpretation of existing standards.</td>
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### Recent Auditing and Attestation Pronouncements and Related Guidance

**PCAOB Staff Questions and Answers, Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees** *(AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 100 par. .05)*

**Issue Date:** April 2007

(Applicable to audits conducted in accordance with PCAOB standards)

Topics covered include the following:
- The application of PCAOB Rule 3522(a), *Tax Transactions* *(AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”), when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm*
- Whether a public accounting firm can advise an audit client on the tax consequences of structuring a particular transaction
- Whether a registered public accounting firm’s independence is affected by the IRS’s subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in PCAOB Rule 3522(b)
- Clarification that the auditor must evaluate whether a person is in a financial reporting oversight role at affiliates and not just the audit client itself
- Clarification of the term *other change in employment event* as it relates to PCAOB Rule 3522(c)

**PCAOB Staff Audit Practice Alert No. 2, Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists** *(AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 400 par. .02)*

**Issue Date:** December 2007

(Applicable to audits conducted in accordance with PCAOB standards)

This practice alert highlights certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of generally accepted accounting principles that are particularly relevant to the current economic environment.
Statement on Standards for Attestation Engagements No. 15 and FDICIA

.162 When reporting on a financial institution’s internal control over financial reporting pursuant to the requirements of the FDICIA, the auditor’s attestation engagement is required to be performed in accordance with AT section 501A, Reporting on an Entity’s Internal Control Over Financial Reporting (AICPA, Professional Standards, vol. 2).

.163 In October 2008, the Auditing Standards Board (ASB) issued Statement on Standards for Attestation Engagements (SSAE) No. 15, An Examination of an Entity’s Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements (AICPA, Professional Standards, vol. 2, AT sec. 501), which establishes standards and provides guidance to practitioners performing an examination of a nonissuer’s internal control over financial reporting (internal control) in the context of an integrated audit (an audit of an entity’s financial statements and an examination of its internal control). SSAE No. 15 converges the standards practitioners use for reporting on a nonissuer’s internal control with PCAOB Auditing Standards No. 5, An Audit of Internal Control That is Integrated with an Audit of Financial Statements (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”). The new standard is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2008 with earlier application permitted. Therefore it is effective for December 31, 2008 audits of financial institutions that are required to have an examination of internal control over financial reporting pursuant to the requirements of the FDICIA.

.164 The new standard establishes requirements that are applicable when an examination of internal control over financial reporting is integrated with an audit of financial statements and contains provisions that will affect both the auditor and the reporting company. The new standard does the following:

- Revises the scope making it applicable only to examinations of the design and operating effectiveness of an entity’s internal control that are integrated with an audit of the entity’s financial statements. Therefore, AT section 501 would no longer be applicable to examinations of the design and operating effectiveness of an entity’s internal control if the financial statements are not also being audited or examinations of only the suitability of the design of an entity’s internal control. (Such engagements may be developed and performed under AT section 101, Attest Engagements [AICPA, Professional Standards, vol. 2]. The ASB is currently developing an interpretation of AT section 101 on reporting on the design of internal control.)
- Requires management’s written assertion about the effectiveness of the entity’s internal control to accompany the practitioner’s report.
- Revises the terms significant deficiency and material weakness to conform with PCAOB Auditing Standard No. 5.
- Revises the list of deficiencies in internal control that are indicators of material weaknesses.
- Eliminates the list of deficiencies that ordinarily would be considered at least significant deficiencies.
- Expands coverage of and adds discussion of a number of various topics including, but not limited to, using a top-down approach for identifying the most important controls to test and incorporating the results of the auditor’s fraud risk assessment from the financial statement audit into planning and performing the examination of internal controls.
- Provides a definition of internal control for reports on certain insured depository institutions under Section 112 of FDICIA.
- Provides an illustrative written communication from the practitioner to management and those charged with governance of any significant deficiencies and material weaknesses.

.165 Readers can assess a summary of the standard and the full text of the standard on the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Authoritative+Standards+and+Related+Guidance+for+Non-Issuers/Summaries+of+Recently+Issued+Auditing+Standards.htm.

AICPA Audit and Accounting Manual

AAM §8050.165
Accounting Issues and Developments

Convergence with International Financial Reporting Standards

166 Since the signing of the Norwalk Agreement by FASB and the International Accounting Standards Board (IASB), the bodies have had a common goal—one set of accounting standards for international use. In this agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. In 2005 meetings, FASB and the IASB reaffirmed their commitment to the convergence of U.S. GAAP and International Financial Reporting Standards (IFRS). A common set of high quality, globally accepted standards remains the long-term strategic priority of both FASB and the IASB.

167 FASB and the IASB have undertaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and IFRS. These ongoing joint projects address the conceptual framework, business combinations, financial statement presentation, and revenue recognition. For more information on the status of this project go to www.fasb.org and www.iasb.org.

SEC Eases Acceptance of IFRS Financial Statements

168 On December 21, 2007, the SEC took a major step toward easing the acceptance of IFRS financial statements by adopting rules to accept from foreign private issuers financial statements prepared in accordance with IFRS as issued by the IASB without reconciliation to U.S. GAAP. This rule marks an important step in the process toward the development of a single set of high quality, globally accepted accounting standards. This rule became effective March 4, 2008. Readers can access this rule at www.sec.gov/rules/final/2007/33-8879.pdf.

169 More than 100 countries now either require or allow the use of IFRS for the preparation of financial statements by listed companies, and additional countries are moving to do the same. This recent movement to IFRS outside the United States has resulted in an increase of filings with the SEC of foreign private issuers that represent in the footnotes to their financial statements that their financial statements comply with IFRS as published by the IASB—from a relative few in 2005 to approximately 110 in 2006. The SEC expects this number will continue to increase in the future, particularly pursuant to Canada’s announced move to IFRS, as there currently are approximately 500 foreign private issuers from Canada.

170 This movement to IFRS also has begun to affect U.S. issuers, in particular those with a significant global footprint. For instance, certain U.S. issuers may compete for capital globally in industry sectors in which a critical mass of non-U.S. companies report under IFRS. Also, U.S. issuers with subsidiaries located in jurisdictions that have moved to IFRS may prepare those subsidiaries’ financial statements in IFRS for purposes of local regulatory or statutory filings. Readers should remain alert to developments regarding convergence.

IFRS “Roadmap”

171 On August 27, 2008, the SEC voted to publish for public comment a proposed roadmap that could lead to the use of IFRS by U.S. issuers beginning in 2014. The SEC would make a decision in 2011 on whether adoption of IFRS is in the public interest and would benefit investors. The proposed multiyear plan sets out several milestones that, if achieved, could lead to the use of IFRS by U.S. issuers in their filings with the SEC.

172 The top 20 companies in each industry, as determined by market capitalization, could elect to begin filing IFRS financial statements for fiscal periods ending after December 15, 2009. If, in 2011, the SEC adopts IFRS for all filers, the roadmap suggests mandatory filing for large accelerated filers beginning in 2014, accelerated filers in 2015, and nonaccelerated filers in 2016. The 90 day comment period ends on February 19, 2009.
The proposed roadmap sets forth seven milestones that will influence the SEC’s decision to adopt IFRS for all filers. These milestones relate to improvements in accounting standards, the accountability and funding of the International Accounting Standards Committee Foundation, the improvement in the ability to use interactive data for IFRS reporting, education and training relating to IFRS, limited early use of IFRS where this would enhance comparability for U.S. investors, the anticipated timing of future rulemaking by the SEC, and the implementation of the mandatory use of IFRS by U.S. issuers.

Additionally, the roadmap discusses two alternatives for U.S. issuers that elect to use IFRS to disclose U.S. GAAP information. Proposal A suggests a U.S. issuer that elects to file IFRS financial statements would provide the reconciling information from U.S. GAAP to IFRS called for under IFRS No. 1, “First-time Adoption of International Financial Reporting Standards,” in a footnote to its audited financial statements. This information would include the restatement of and reconciliation from prior year’s financial statements and the related disclosures.

Proposal B suggests that U.S. issuers that elect to file IFRS financial statements would provide the reconciling information from U.S. GAAP to IFRS required under IFRS No. 1, and would also disclose on an annual basis certain unaudited supplemental U.S. GAAP financial information covering a three year period. This unaudited supplemental financial information would be in the form of a reconciliation from IFRS to U.S. GAAP.

The roadmap does not address how the SEC would mandate IFRS; however, noted, an option would be for FASB to continue to be the designated standard setter for purposes of establishing the financial reporting standards in issuer filings with the Commission. In this option our presumption would be that FASB would incorporate all provisions under IFRS, and all future changes to IFRS, directly into generally accepted accounting principles as used in the United States. This type of approach has been adopted by a significant number of other jurisdictions when they adopted IFRS as the basis of financial reporting in their capital markets.


AICPA Launches IFRS.com Web Site

The AICPA is calling for an orderly transition and reasonable time frame of three to five years for the U.S. accounting profession to adopt IFRS. During a FASB forum on June 16, 2008, held to facilitate an open dialogue about whether and how to move the U.S. financial reporting system to IFRS and define next steps in that process, it was noted that awareness of IFRS is growing, but most believe it will take three to five years to prepare.

To assist in both awareness building and education, the AICPA launched a new Web site, www.ifrs.com, in May 2008. The site provides current information about developments in international convergence. The growing acceptance of IFRS as a basis for U.S. financial reporting represents a fundamental change for the U.S. accounting profession. Acceptance of a single set of high-quality accounting standards for worldwide use by public companies has been gaining momentum around the globe for the past few years.

Developed by the AICPA, in partnership with its marketing and technology subsidiary, CPA2Biz, IFRS.com provides a comprehensive set of resources for accounting professionals, auditors, financial managers, audit committees, and other users of financial statements.

The Web site features tools and resources to help CPAs get acquainted with IFRS, the surrounding issues, and available support. Resources include a history of convergence, a high-level overview of the differences between IFRS and U.S. GAAP, frequently asked questions, articles, textbooks, CPE courses and live conference training, helpful links, and assistance for audit committee members.
FASB Accounting Standards Codification™

.182 On January 15, 2008, FASB launched the one-year verification period of the FASB Accounting Standards Codification™ (ASC). FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing all authoritative literature in a topically organized structure. FASB ASC includes all accounting standards issued by a standard setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, AICPA, EITF, and related literature. FASB ASC also includes relevant authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance.

.183 The purpose of FASB ASC is not to change GAAP, but rather to reorganize thousands of GAAP pronouncements into approximately 90 topics. At the end of the one-year verification period, FASB is expected to formally approve FASB ASC as the single source of authoritative U.S. accounting and reporting standards, other than guidance issued by the SEC. At that time, FASB will supersede all then-existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the codification will become nonauthoritative. FASB expects to approve FASB ASC in April 2009. FASB ASC can be accessed at http://asc.fasb.org/home.

.184 Constituents are encouraged to use the online FASB ASC Research System free of charge and provide feedback to FASB on the codification.

.185 The AICPA has published the Financial Reporting Alert FASB Codification Developments—2008 (product no. 029209kk). This Financial Reporting Alert is intended to provide a better understanding of FASB ASC, outline its structure, as well as provide case studies on navigating the FASB ASC Research System and perform accounting research.

Summary of Recent Accounting Pronouncements and Related Guidance

.186 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. This alert is intended to be used in conjunction with the Comprehensive Audit Risk Alert—2008 (product no. 022339kk); therefore, only industry specific pronouncements and related guidance or those of specific significance to the industry are summarized herein. For information on accounting standards issued subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the CPA Letter and Journal of Accountancy.

<table>
<thead>
<tr>
<th>FASB Statement No.</th>
<th>Recent Accounting Pronouncements and Related Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>163 (May 2008)</td>
<td>Accounting for Financial Guarantee Insurance Contracts—an interpretation of FASB Statement No. 60</td>
</tr>
<tr>
<td>162 (May 2008)</td>
<td>The Hierarchy of Generally Accepted Accounting Principles</td>
</tr>
<tr>
<td>161 (March 2008)</td>
<td>Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133</td>
</tr>
<tr>
<td>160 (December 2007)</td>
<td>Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51</td>
</tr>
<tr>
<td>141 (revised 2007)</td>
<td>Business Combinations</td>
</tr>
</tbody>
</table>

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## Recent Accounting Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Statement/Interpretation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>FASB Statement No. 158 (September 2006)</td>
<td>Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)</td>
</tr>
<tr>
<td>FASB Statement No. 157 (September 2006)</td>
<td>Fair Value Measurements</td>
</tr>
<tr>
<td>FASB Interpretation No. (FIN) 48 (June 2006)</td>
<td>Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109</td>
</tr>
<tr>
<td>FASB Staff Position (FSP) FIN 48-2, Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises, issued in February 2008, defers the effective date of FIN 48 for certain nonpublic enterprises, as defined in the FSP, to the annual financial statements for fiscal years beginning after December 15, 2007.</td>
<td></td>
</tr>
<tr>
<td>FASB Emerging Issues Task Force (EITF) Issues (Various dates)</td>
<td>Go to <a href="http://www.fasb.org/eitf/agenda.shtml">www.fasb.org/eitf/agenda.shtml</a> for a complete list of EITF issues.</td>
</tr>
<tr>
<td>FASB Staff Positions (Various dates)</td>
<td>Go to <a href="http://www.fasb.org/fasb_staff_positions/">www.fasb.org/fasb_staff_positions/</a> for a complete list of FSPs.</td>
</tr>
<tr>
<td>AICPA SOP 07-1 (AICPA, Technical Practice Aids, ACC sec. 10,930)</td>
<td>Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies</td>
</tr>
<tr>
<td>In February 2008, FASB issued FSP SOP 07-1-1, Effective Date of AICPA Statement of Position 07-1, which indefinitely defers the effective date of SOP 07-1 before December 15, 2007 are permitted, but not required, to continue to apply the provisions of the SOP. No other entities may adopt the provision of the SOP, subject to the exception in the following sentence: if a parent entity that early adopted the SOP chooses not to rescind its early adoption, an entity consolidated by the parent entity that is formed or acquired after that parent entity’s adoption of the SOP must apply the provisions of the SOP in its stand-alone financial statements.</td>
<td></td>
</tr>
<tr>
<td>TIS section 1100.15 (AICPA, Technical Practice Aids) (Nonauthoritative)</td>
<td>This question and answer discusses auditing and accounting issues related to withdrawal restrictions placed on short term investments by a money market fund or its trustee.</td>
</tr>
<tr>
<td>TIS sections 6910.25–.28 (AICPA, Technical Practice Aids) (Nonauthoritative)</td>
<td>These questions and answers discuss financial statement presentation considerations for investment companies.</td>
</tr>
<tr>
<td>TIS sections 6140.20–.22 (AICPA, Technical Practice Aids) (Nonauthoritative)</td>
<td>These questions and answers discuss not-for-profit organizations fund-raising expenses.</td>
</tr>
</tbody>
</table>

(continued)
Recent Accounting Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>TIS section 6931.08-.10 (AICPA, Technical Practice Aids) (Nonauthoritative)</th>
<th>These questions and answers discuss various employee benefit plan topics.</th>
</tr>
</thead>
<tbody>
<tr>
<td>AICPA Practice Guide (Nonauthoritative)</td>
<td>Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48</td>
</tr>
</tbody>
</table>

.187 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance to the financial institutions industry are briefly explained here. The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. The Comprehensive Audit Risk Alert—2008 and other AICPA industry-specific alerts also contain summaries of recent pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or visit www.cpa2biz.com.

FASB Statement No. 163

.188 In May 2008, FASB issued Statement No. 163, Accounting for Financial Guarantee Insurance Contracts—an interpretation of FASB Statement No. 60. The scope of FASB Statement No. 163 is limited to financial guarantee insurance and reinsurance contracts issued by enterprises included in FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises. Financial guarantee insurance and reinsurance contracts obligate the insurance enterprise to pay a claim upon the occurrence of an event of default. This statement does not apply to enterprises excluded from FASB Statement No. 60, financial guarantee insurance contracts that are accounted for as derivative instruments within the scope of FASB Statement No. 133, and some insurance contracts that are similar to financial guarantee insurance contracts issued by insurance enterprises (such as mortgage guaranty insurance and credit insurance on trade receivables).

.189 The new standard clarifies how FASB Statement No. 60 applies to financial guarantee insurance contracts issued by insurance enterprises. This includes the recognition and measurement of premium revenue and claim liabilities. The statement also requires expanded disclosures about financial guarantee insurance contracts. The provisions of FASB Statement No. 163 should be applied on a contract-by-contract basis.

.190 The accounting and disclosure requirements of FASB Statement No. 163 are intended to improve the comparability and quality of information provided to users of financial statements by creating consistency; for example, in the measurement and recognition of claim liabilities. The statement requires that an insurance enterprise recognize a claim liability prior to an event of default (insured event) when there is evidence that credit deterioration has occurred in an insured financial obligation. It also requires disclosure about (a) the risk-management activities used by an insurance enterprise to evaluate credit deterioration in its insured financial obligations and (b) the insurance enterprise’s surveillance or watch list.

.191 FASB Statement No. 163 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and all interim periods within those fiscal years. However, select disclosure requirements are effective for the first period (including interim periods) beginning after the issuance of this statement. Besides those select disclosures, early adoption is prohibited.

.192 To read FASB Statement No. 163 in its entirety, visit the FASB Web site at www.fasb.org.

Disclosures About Derivative Instruments and Hedging Activities

.193 In March 2008, FASB issued Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133. The new standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable
investors to better understand their effects on an entity’s financial position, financial performance, and cash flows.

194 The new standard improves transparency about the location and amounts of derivative instruments in an entity’s financial statements; how derivative instruments and related hedged items are accounted for under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*; and how derivative instruments and related hedged items affect its financial position, financial performance, and cash flows.

195 FASB Statement No. 161 achieves these improvements by requiring disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also provides more information about an entity’s liquidity by requiring disclosure of derivative features that are credit risk-related. Finally, it requires cross-referencing within footnotes to enable financial statement users to locate important information about derivative instruments. It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged.

**Fair Value Measurements**

*FASB Statement No. 157*

196 In September 2006, FASB issued Statement No. 157 to provide enhanced guidance for using fair value to measure assets and liabilities. This standard defines fair value and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances.

197 Prior to this statement, there were different definitions of fair value, and guidance for applying those definitions was dispersed among many accounting pronouncements. Difference in the existing guidance created inconsistencies that added to the complexity in applying GAAP. FASB Statement No. 157 provides increased consistency and comparability in fair value measurements. Expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the use of fair value in the financial statements, the inputs used to develop the measurements, and the effect of the measurements on earnings (or changes in net assets) for the period.

198 In February 2008, FASB issued FSP FAS 157-1, *Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13*, which amends FASB Statement No. 157, to exclude FASB Statement No. 13, *Accounting for Leases*, and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under FASB Statement No. 13. However, this scope exception does not apply to assets acquired and liabilities assumed in a business combination that are required to be measured at fair value under FASB Statement No. 141, *Business Combinations*, or FASB Statement No. 141 (revised 2007), *Business Combinations*, regardless of whether those assets and liabilities are related to leases. This FSP is effective upon the initial adoption of FASB Statement No. 157.

199 FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. Early adoption is permitted. However, in February 2008, FASB also issued FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, which is effective upon issuance. This FSP delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008 and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow FASB and its constituents the time to consider the various implementation issues associated with FASB Statement No. 157. In October 2008, FASB issued FSP FAS 157-3, which clarifies FASB Statement No. 157’s application in an inactive market and also amends the standard to include an illustrative example. See the section of this alert “Measurements of Fair Value in Illiquid Markets” for further discussion of FSP FAS 157-3. Readers can
access the full text of FASB Statement No. 157 and the previously referenced FSPs on the FASB Web site at www.fasb.org.

**FASB Statement No. 159**

.200 Subsequent to the issuance of FASB Statement No. 157, FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*. This statement is expected to expand the use of fair value measurement, which is consistent with FASB’s long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159 allows entities to choose to measure many financial instruments and certain other items at fair value. FASB Statement No. 159 allows entities to choose to measure many financial instruments and certain other items at fair value. The standard permits an entity to elect the fair value option on an instrument-by-instrument basis; and once the election is made, it is irrevocable. This statement’s objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently, without having to apply complex hedge accounting provisions.

.201 In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and FASB Statement No. 157.

.202 FASB Statement No. 159 is effective as of the beginning of an entity’s first fiscal year that begins after November 15, 2007. FASB and the SEC expressed concern in the way some early adopters applied the transition provisions of the standard. The CAQ issued an alert on this development in April 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles-based standard, such as this, is applied in a good faith manner consistent with those objectives and principles. Specifically, the alert warns auditors to “be alert for circumstances in which an entity proposes to adopt FASB Statement No. 159 in a manner that is contrary to the principles and objectives outlined in the standard.” The alert can be accessed at www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf. Readers can access the full text of FASB Statement No. 159 on the FASB Web site at www.fasb.org.

**Recent AICPA Independence and Ethics Pronouncements**

.203 AICPA Audit Risk Alert *Independence and Ethics Developments—2008* (product no. 022479kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

**On the Horizon**

.204 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to the financial institutions industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.205 The following table lists the various standard-setting bodies’ Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.
Auditing Pipeline—Nonissuers

*ASB Clarity Project*

.206 In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the next two or three years, the ASB will be redrafting all of the existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU sections of the AICPA’s *Professional Standards*), to apply the clarity drafting conventions and to converge with the International Standards on Auditing issued by the International Auditing and Assurance Standards Board. The ASB proposes that, except to address current issues, all redrafted standards will become effective at the same time. Only those standards needing to address current issues would have earlier effective dates. The ASB believes that a single effective date will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. Currently, the date is expected to be for audits of financial statements for periods beginning no earlier than December 15, 2010. This date depends on satisfactory progress being made, and will be amended should that prove necessary. See the Clarity Project Explanatory Memorandum and the discussion paper *Improving the Clarity of ASB Standards* at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm.

**Auditing Pipeline—Issuers**

.207 Guidance issued by the PCAOB is included in the section of this alert titled “Summary of Recent Auditing and Attestation Pronouncements and Related Guidance.” For more information regarding recent developments at both the SEC and PCAOB, readers may refer to Audit Risk Alert *SEC and PCAOB Developments—2008*.

**Accounting Pipeline**

.208 There are a number of accounting projects and pronouncements currently in progress. For a summary of significant accounting projects and pronouncements, refer to *Comprehensive Audit Risk Alert—2008* (product no. 022339kk). Such in progress issues include the following:

- Accounting for hedging activities exposure draft
- Accounting for contingencies exposure draft
- Phase 2 of the fair value project
- Transfers of financial assets project
- Earnings per share convergence project
• Income tax convergence project
• Leases project
• Reporting discontinued operations project
• Going concern proposed statement
• Subsequent events proposed statement
• Amendments to FASB Interpretation No. (FIN) 46(R), *Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51*, proposed statement

**Proposed FASB EITF Issues and FSPs**

.209 *Proposed FASB EITF Issues*. Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

.210 *Proposed FSPs*. A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

**Resource Central**

.211 The following are various resources that practitioners engaged in the financial institutions industry may find beneficial.

**Publications**

.212 Practitioners may find the following publications useful. Choose the format best for you—online, print, or CD-ROM.

• Audit and Accounting Guide *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies* (2008) (product no. 012738kk [paperback], WDL-XX [online with the associated Audit Risk Alert], or DDL-XX [CD-ROM with the associated Audit Risk Alert])

• Audit and Accounting Guide *Investment Companies* (2008) (product no. 012628kk [paperback], WIN-XX [online with the associated Audit Risk Alert], or DIN-XX [CD-ROM with the associated Audit Risk Alert])

• Audit Guide *Analytical Procedures* (2008) (product no. 012558kk [paperback], WAN-XX [online], or DAN-XXkk [CD-ROM])

• Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk [paperback] or WRA-XX [online])

• Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2008) (product no. 012528kk [paperback], WDI-XX [online], or DDI-XX [CD-ROM])

• Audit Guide *Audit Sampling* (2008) (product no. 012538kk [paperback], WAS-XX [online], or DAS-XX [CD-ROM])

• Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2008) (product no. 012778kk [paperback], WSV-XX [online], or DSV-XX [CD-ROM])

• Comprehensive Audit Risk Alert—2008 (product no. 022339kk [paperback], WGE-XX [online], or DGE-XX [CD-ROM])

• Audit Risk Alert *Independence and Ethics Developments—2008* (product no. 022479kk [paperback], WIA-XX [online], or DIA-XX [CD-ROM])

• Audit Risk Alert *SEC and PCAOB Developments—2008* (product no. 022499kk [paperback])
• Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk [paperback])

• *Checklists and Illustrative Financial Statements for Depository and Lending Institutions* (2008) (product no. 008919 [paperback] or WDP-CL [online])

• *Audit and Accounting Manual* (2008) (product no. 005138kk [paperback], WAM-XX [online], or AAM-XX [loose leaf])

• *Accounting Trends & Techniques, 62nd Edition* (product no. 009900kk [paperback] or WAT-XX [online])

.213 Additional resources for accountants in business and industry are the Financial Reporting Alert series, designed to be used by members of an entity’s financial management and audit committee to identify and understand current accounting and regulatory developments affecting the entity’s financial reporting.

• Financial Reporting Alert *Current Accounting Issues and Risks—2008* (product no. 029208kk [paperback])

• Financial Reporting Alert *FASB Codification Developments—2008* (product no. 029209kk [paperback])

**AICPA reSOURCE: Accounting and Auditing Literature**

.214 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm’s needs. Or, if you prefer to have access to the entire library, that is available too. Get access—anytime, anywhere—to the AICPA’s latest *Professional Standards*, *Technical Practice Aids*, *Audit and Accounting Guides* (more than 20), *Audit Risk Alerts* (more than 15), and *Accounting Trends & Techniques*. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

**Continuing Professional Education**

.215 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

• *AICPA’s Annual Accounting and Auditing Update Workshop (2008–2009 Edition)* (product no. 736184kk [text] or 187192kk [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.

• *SEC Reporting* (product no. 736775kk [text] or 186756kk [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.

• *International Versus U.S. Accounting: What in the World is the Difference?* (Product no. 731666kk [text]). With the fast pace of the convergence project, understanding the differences between IFRS and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRS and U.S. GAAP.

• *The International Financial Reporting Standards: An Overview* (product no. 157220kk [online] or 739750HSkk [DVD]). This course captures a live presentation on IFRS given to the AICPA Board of Directors.

.216 Among the many courses, *Audits of Banks and Other Financial Institutions* (product no. 733440kk [self study]) offers industry-specific information you may find useful. Visit www.cpa2biz.com for a complete list of CPE courses.

**Online CPE**

.217 AICPA CPEExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is the AICPA’s flagship online learning product. AICPA members pay $180 for a new subscription and $149 for
the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPEExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to the financial institutions industry include the following:

- Auditing Financial Institutions: Cash, Investments, Intangibles, Real Estate, and Deposits
- Auditing Financial Institutions: Credit Losses
- Auditing Financial Institutions: Equity, Capital, and Capital Disclosures
- Auditing Financial Institutions: Regulatory and Government Supervision Plus General Auditing and Reporting Issues
- Revenue Recognition: Depository and Lending Institutions, Health Care, Insurance, Real Estate

To register or learn more, visit www.cpa2biz.com.

Webcasts

Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession’s leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of “hot topics” that successful organizations employ and subjects that are important to the CFO’s personal success. From financial reporting and budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession’s leading experts on what is “hot” at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you “plugged in” to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA’s Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. Beginning January 14, 2008, hotline hours were extended so that the hotline is now available from 9 a.m. to 8 p.m. on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/.
Ethics Hotline

.224 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA’s Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077.

Industry Conference

.225 The AICPA offers an annual National Banking School. The National Banking School, next offered in May 2009, covers every major aspect of bank operations and accounting using case studies, classroom discussion, and a simulated bank environment. The AICPA also offers a National Conference on Banks and Savings Institutions. The National Conference on Banks and Savings Institutions is a three-day conference designed to update attendees on recent developments related to audit, accounting, regulatory and legislative, and tax issues affecting the industry. For further information about these, call (888) 777-7077 or visit www.cpa2biz.com.

The CAQ

.226 The CAQ, which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ’s mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession’s core values of integrity, objectivity, honesty, and trust.

.227 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit http://thecaq.aicpa.org.

AICPA Industry Expert Panel—Depository Institutions

.228 For information about the activities of the AICPA Depository Institutions Expert Panel, visit the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_depository.htm.

Industry Web Sites

.229 The Internet covers a vast amount of information that may be valuable to auditors of financial institutions, including current industry trends and developments. Some of the more relevant sites for auditors with financial institution clients include those shown in the following table:

<table>
<thead>
<tr>
<th>Organization</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Deposit Insurance Corporation</td>
<td><a href="http://www.fdic.gov">www.fdic.gov</a></td>
</tr>
<tr>
<td>Financial Crimes Enforcement Network</td>
<td><a href="http://www.fincen.gov/">www.fincen.gov/</a></td>
</tr>
<tr>
<td>Mortgage Bankers Association</td>
<td><a href="http://www.mbaa.org/">www.mbaa.org/</a></td>
</tr>
<tr>
<td>National Credit Union Administration</td>
<td><a href="http://www.ncua.gov/">www.ncua.gov/</a></td>
</tr>
</tbody>
</table>

(continued)
The financial institutions practices of some of the larger CPA firms may also contain industry-specific auditing and accounting information that is helpful to auditors.

* * * *

This Audit Risk Alert replaces Bank, Credit Union, and Other Depository and Lending Institution Industry Developments—2007/08.

The Audit Risk Alert Depository and Lending Institution Industry Developments is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year’s Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to kbiser@aicpa.org or write to

Kenneth R. Biser, CPA, MBA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110
Appendix—Additional Web Resources
Here are some useful Web sites that may provide valuable information to accountants.

<table>
<thead>
<tr>
<th>Web Site Name</th>
<th>Content</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>American Institute of CPAs (AICPA)</td>
<td>Summaries of recent auditing and other professional standards as well as other AICPA activities</td>
<td><a href="http://www.aicpa.org">www.aicpa.org</a>&lt;br&gt;www.cpa2biz.com&lt;br&gt;www.ifrs.com</td>
</tr>
<tr>
<td>AICPA Accounting Standards Executive Committee (AcSEC)</td>
<td>Issues guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards</a></td>
</tr>
<tr>
<td>AICPA Accounting and Review Services Committee (ARSC)</td>
<td>Develops and issues review and compilation standards and interpretations</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee</a></td>
</tr>
<tr>
<td>AICPA Professional Issues Task Force (PITF)</td>
<td>Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force</a></td>
</tr>
<tr>
<td>Economy.com</td>
<td>Source for analysis, data, forecasts, and information on the United States and world economies</td>
<td><a href="http://www.economy.com">www.economy.com</a></td>
</tr>
<tr>
<td>The Federal Reserve Board</td>
<td>Key interest rates</td>
<td><a href="http://www.federalreserve.gov">www.federalreserve.gov</a></td>
</tr>
<tr>
<td>Financial Accounting Standards Board (FASB)</td>
<td>Summaries of recent accounting pronouncements and other FASB activities</td>
<td><a href="http://www.fasb.org">www.fasb.org</a></td>
</tr>
<tr>
<td>USA.gov</td>
<td>Portal through which all government agencies can be accessed</td>
<td><a href="http://www.usa.gov">www.usa.gov</a></td>
</tr>
<tr>
<td>International Accounting Standards Board (IASB)</td>
<td>Summaries of International Financial Reporting Standards and International Accounting Standards</td>
<td><a href="http://www.iasb.org">www.iasb.org</a></td>
</tr>
<tr>
<td>International Auditing and Assurance Standards Board (IAASB)</td>
<td>Summaries of International Standards on Auditing</td>
<td><a href="http://www.iaasb.org">www.iaasb.org</a></td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>Web Site Name</th>
<th>Content</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>International Federation of Accountants (IFAC)</td>
<td>Information on standards-setting activities in the international arena</td>
<td><a href="http://www.ifac.org">www.ifac.org</a></td>
</tr>
<tr>
<td>Private Company Financial Reporting Committee (PCFRC)</td>
<td>Information on the initiative to further improve FASB’s standard-setting process to consider needs of private companies and their constituents of financial reporting.</td>
<td><a href="http://www.pcfrc.org">www.pcfrc.org</a></td>
</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
<td>Information on accounting and auditing the activities of the PCAOB and other matters</td>
<td><a href="http://www.pcaob.org">www.pcaob.org</a></td>
</tr>
</tbody>
</table>

[The next page is 8161.]
AAM Section 8060

Employee Benefit Plans Industry Developments—2009

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of employee benefit plans with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an other auditing publication as defined in AU section 150, Generally Accepted Auditing Standards (AICPA, Professional Standards, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Linda C. Delahanty, CPA
Technical Manager
Audit and Attest Standards

Acknowledgments

The AICPA staff gratefully acknowledges the Employee Benefit Plans Guide Task Force; the Office of the Chief Accountant, the Employee Benefits Security Administration; and JulieAnn Verrekia for their essential contributions in creating this publication.

How This Alert Helps You

.01 This Audit Risk Alert helps you plan and perform your employee benefit plan audits and also can be used by an entity’s internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may result in the material misstatement of financial statements and delivers information about emerging practice issues and current accounting, auditing, and regulatory developments. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.02 Paragraph .01 of AU section 314, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (AICPA, Professional Standards, vol. 1), establishes requirements and provides guidance about implementing the second standard of field work, as follows: “The auditor must obtain a sufficient
understanding of the entity and its environment, including its internal control, to assess the risks of material
misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and
extent of further audit procedures.” Just as the external environment changes, the handling of the entity’s
business is also dynamic, and the entity’s strategies and objectives change over time. An understanding of
business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does
not have a responsibility to identify or assess all business risks. Most business risks will eventually have
financial consequences and, therefore, an effect on the financial statements. However, not all business risks
give rise to risks of material misstatement.

Economic and Industry Developments

The Current Economic Crisis

.03 When planning and performing an audit of an employee benefit plan, an auditor should understand
the economic conditions facing the industry in which the plan sponsor operates as well as the effects of these
conditions on the employee benefit plan. Economic activities relating to factors such as interest rates,
availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor
market conditions are likely to have an effect on the audit of the plan’s financial statements. Although it is
impossible to predict and include all accounting, auditing, and attestation issues that may affect employee
benefit plan audits, the primary areas of concern given the current economic conditions are described in this
alert. As always, continue to remain alert to changes in economic, legislative, and regulatory developments
as well as the associated accounting, auditing, and attestation issues as you perform your engagements.

.04 Recent economic conditions and regulatory actions may cause additional risk factors that had not
previously existed or did not have a material effect on the audit of the plan in prior years. Some challenges
that may affect the plan in the current economic conditions are as follows:

- Constraints on the availability of capital and credit
- The credit crisis, which results in significant measurement uncertainty, including accounting esti-
mates and fair value measurements
- Operations that are exposed to volatile markets, such as currency markets
- Volatile real estate markets
- Severely underfunded defined benefit plans
- Downsizing causing significant layoffs
- Going concern and liquidity issues
- Fraudulent internal and external transactions

.05 Although many of these risks are not new for plan audits, consideration of the ways an employee
benefit plan is affected by external forces is part of obtaining an understanding of the plan and its environment
and will allow the auditor to plan and perform the audit to address those risks. As noted in paragraph .17
of AU section 312, Audit Risk and Materiality in Conducting an Audit (AICPA, Professional Standards, vol. 1), some
possible audit responses to a significant risk of material misstatement include increasing the extent of audit
procedures, performing procedures closer to year-end, or increasing audit procedures to obtain more
persuasive evidence. Additionally, given the constant changing status of economic conditions that could affect
your plan audit, auditors should consider modifying audit procedures to ascertain that risks are still
adequately addressed.

.06 Currently, the U.S. economy continues to experience severe instability. The National Bureau of
Economic Research officially declared that, as of December 2007, the United States slid into a recession. The
length of the recession and whether the United States will enter into a depression are yet to be determined.
Some key occurrences that exhibit the gravity of the economic crisis include the following:
• Government intervention in the private sector has increased. Numerous financial institutions and automakers have received a bailout from the government.

• Millions of households owe more on their mortgages than their homes are currently worth. The number of residential home foreclosures has increased to record levels; in January 2009, foreclosures were up 18 percent from January 2008.

• The number of jobless claims has continued to increase; the economy has experienced the biggest job loss since the end of World War II.

• U.S. real gross domestic product (GDP), the broadest measure of economic activity, continues to decrease at an increasing rate.

• The financial markets continue to experience instability. At the end of February 2009, the S&P 500 hit a 12-year low. Likewise, the Dow Jones Industrial Average and NASDAQ also continue to hit long-time lows.

• The Federal Reserve has continued to decrease the federal fund interest rate.

• The demand for U.S. Treasury bills has increased at a staggering rate, which drove the interest rate for these Treasury bills to less than 1 percent in February 2009.

• The Treasuries Over Eurodollar Spread reached 4.63 percent in October 2008, a historic high.

• The discovery of alleged frauds in hedge funds or in other alternative investments has caused investors to lose millions of dollars.

• Certain investments that were once considered safe investments, such as money market funds and securities lending activities, have “broken the buck” and are now experiencing write downs.

Some experts have attributed the current situation with the residential real estate industry to the perfect storm of circumstances: rising home values, historically low interest rates, loosening underwriting and lending standards, and the notion that housing was a fail-safe investment. As these problems with the real estate market became evident, they have had a significant effect on the credit market. As the credit markets have become frozen and banks have become unwilling to lend to consumers or to one another, the downward sloping cycle perpetuates, resulting in continued stress on the overall economy.

One major spillover effect of these events has been in the market for short term commercial paper, particularly securities backed by various financial assets. Various money market funds (both registered and unregistered) have acknowledged investments in troubled paper. They have enhanced their procedures to monitor the differences between net asset value as determined using amortized cost and market values of securities, as required by Rule 2a-7 under the Investment Company Act of 1940 or other equivalent regulations. Some money market funds may have material differences between amortized cost and the market value of securities, resulting in a share value reported in the audited financial statements that is different than what is used for participant transactions and reported on the trustee or custodial statements at year-end.

Government Intervention to Curtail the Economic Crisis

Due to the economic crisis, the U.S. government has taken unprecedented actions to prevent worsening economic conditions, including passing the American Recovery and Reinvestment Act of 2009 (ARRA) in February 2009 and the Emergency Economic Stabilization Act of 2008 (EESA), facilitating the sale of ailing banks, and dramatically increasing the monetary programs available from the Federal Reserve.

The EESA was signed into law in October 2008. As stated in Section 2 of the EESA bill, it “provide[s] authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system of the United States” to ensure the economic wellbeing of Americans. Certain components of the EESA bill include the following:

• An allocation of $700 billion to stabilize the U.S. financial system

• The creation of an oversight board
• A temporary increase of Federal Deposit Insurance Corporation insurance limits
• The restatement of the Securities and Exchange Commission’s (SEC’s) authority to suspend the application of Financial Accounting Standards Board (FASB) Statement No. 157, Fair Value Measurements, (which is codified at FASB Accounting Standards Codification [ASC] 820, Fair Value Measurements and Disclosures)

.11 In February 2009, President Obama signed legislation designed to work hand in hand with the EESA to stimulate the U.S. economy. The ARRA is designed primarily to combat the rising unemployment trend, put more money in the hands of consumers, and reduce the likelihood that state and local governments will need to raise taxes significantly.

.12 Many of the provisions of this legislation took effect immediately in an effort to stimulate consumer spending and boost the economy. The total cost of the spending in the ARRA is $787 billion, which is in addition to the $700 billion in the EESA. Many economists are concerned that further financial support may be necessary before an economic recovery is possible. Additionally, the federal government developed the Web site www.recovery.gov to facilitate a transparent process to ensure accountability for the execution of the package.

.13 The complete effects of the ARRA as well as the other government interventions will take time to be felt throughout the economy; however, the primary goal is to first increase market confidence and liquidity.

Effect on Employee Benefit Plans

.14 Pricing services typically used by plan trustees or custodians to provide investment prices, such as Interactive Data Pricing and Reference Data, have issued press releases to inform users that they are experiencing difficulties in obtaining consistent market information in the production of valuations of subprime-related securities. Therefore, certain service providers have enhanced their procedures to respond to these issues including, among other things, more frequent monitoring of the differences between amortized cost and the market value of securities for money market funds and close monitoring of the portfolios for exposure to these markets and the associated valuations of these securities.

.15 Additionally, the risks related to securities lending have become too great for the incremental income that can be earned. These risks recently surfaced in investment vehicles where managers of securities lending programs invest the cash collateral they receive from borrowers. That collateral was typically 102 percent of domestic shares and 105 percent of the value of non-U.S. shares. Institutional investors thought the collateral was invested in “safe” securities. Unfortunately, the range of permissible investments expanded into asset-backed securities and home equity loans. Both of these events are causing liquidity issues for plans and plan sponsors. See paragraphs .130–.132 for further discussion of securities lending.

.16 The credit crisis also raises concerns among plan sponsors about the ability for insurance companies to pay out claims on the annuity products sold to benefit plans and the safety of guaranteed annuities. Insurance companies are now hoping that the government has funds for a bail out program for them.

.17 Also, due to the significant upheaval in the current market, auditors may want to pay particular attention to the plan’s liquidity, and whether the current conditions could affect the plan sponsor and plan’s ability to continue as a going concern. AU section 341, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern (AICPA, Professional Standards, vol. 1), requires auditors to evaluate whether there is substantial doubt about an entity’s ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. AU section 380, The Auditor’s Communication With Those Charged With Governance (AICPA, Professional Standards, vol. 1), requires that auditors communicate with those charged with governance events or conditions that lead the auditor to believe there is substantial doubt about the entity’s ability to continue as a going concern. See paragraphs .65–.70 for further discussion of going concern matters in an employee benefit plan audit.
Events or transactions sometimes occur that affect the fair value of financial instruments, subsequent to the balance-sheet date but prior to the issuance of the financial statements that have a material effect on the financial statements and therefore require adjustment or disclosure in the statements. The determination of whether such information represents a type 1 or type 2 subsequent event is highly judgmental and will be based on the specific facts and circumstances. For example, the subsequent events procedure to review trustee or custodial statements after year-end may identify pricing adjustments to investment accounts. Auditors may consider if the adjustment resulted from specific market events occurring (a) after year-end (type 2 event) or (b) as of year-end (type 1). Type 1 subsequent events may need to be recorded as an adjustment to the year-end financial statements. See AU section 560, Subsequent Events (AICPA, Professional Standards, vol. 1), for further guidance. Flexibility in auditing procedures will help the auditor to respond to changes in market conditions.

In addition, auditors should consider the requirements of Statement of Position (SOP) 94-6, Disclosure of Certain Significant Risks and Uncertainties (AICPA, Technical Practice Aids, ACC sec. 10,640), about disclosing significant risks and uncertainties in the plan’s financial statements at year-end regarding investments affected by subprime, illiquid, or other market events. The following is an example of such a disclosure:

The plan invests in securities with contractual cash flows, such as asset backed securities, collateralized mortgage obligations and commercial mortgage backed securities, including securities backed by subprime mortgage loans. The value, liquidity and related income of these securities are sensitive to changes in economic conditions, including real estate value, delinquencies or defaults, or both, and may be adversely affected by shifts in the market’s perception of the issuers and changes in interest rates.

Additional disclosures may also be required related to defined benefit plans due to the deficit between plan assets and the plan’s accumulated plan benefit obligations and funding requirements.

The current economic crisis may result in unexpected losses and possibly cause financing or liquidity difficulties for many plans and plan sponsors. Additionally, plan sponsors may be valuing illiquid securities using inherently subjective methodologies. These situations may provide plan management additional opportunity and incentive to commit fraud.

As seen in the news recently, a number of frauds allegedly have occurred. One of those frauds is that of Bernard Madoff Investment Securities. Although the details of this fraud are just beginning to be investigated, the planning and design of testing for the existence of assets, such as investments, is important. In addition, the requirements in AU section 314 are further emphasized in light of this alleged scenario. In this scenario, auditors are being probed about failing to question the strong, consistent annual returns by these investment funds that lacked a clear investment strategy. Because of the characteristics of fraud, the auditor’s exercise of professional skepticism is important when considering the risk of material misstatement due to fraud.

Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor’s belief about management’s honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), provides additional information including ways for the auditor to respond to the risk of material misstatement due to fraud.

Due to the current economic crisis and the recent developments involving financial frauds in managed investment funds, the U.S. Department of Labor (DOL) is expanding the scope of its inspection programs to consider the current status of the investments being reviewed. The DOL plans to emphasize its focus on how plan management determines that investments exist and that their values have been adjusted to reflect the current market conditions.

Additional areas of fraudulent transactions could result due to the economic crisis related to the operation of the plan. Defalcations, inappropriate vesting of participants, ineligible participants included in

AICPA Audit and Accounting Manual
the plan, and inappropriate assumptions for Defined Benefit and Health and Welfare plan obligations are possible areas to consider.

.26 AU section 316 is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement (whether the material misstatement was caused by error or fraud as stated in paragraph .02 of AU section 110, Responsibilities and Functions of the Independent Auditor [AICPA, Professional Standards, vol. 1]).

.27 In addition, the significant number of layoffs at plan sponsors will affect employee benefit plans. For a defined benefit pension plan, this may add to the liquidity issues that the plan faces. For a defined contribution plan, a provision of the Internal Revenue Code (IRC) requires that all participants be fully vested in the event of a partial termination. This is a technical term that does not have a clear definition. It has been interpreted to apply where 20 percent or more of the workers have lost their jobs due to an event such as a plant closing or economic downturn. Because many plans use forfeitures to reduce employer contributions or to pay expenses, it is important for the client to properly identify when such a partial termination has occurred. See paragraph 12.21 of the Audit and Accounting Guide Employee Benefit Plans for further guidance.

**Resources for Economic Information**

.28 The Internet covers a vast amount of information that you may find valuable. See appendix E for some of the sites not previously mentioned in this section and links to relevant documents regarding economic information.

**Hot Topics**

**Fair Value Measurements and Disclosures**

*AASB Statement No. 157*

.29 In September 2006, FASB issued FASB Statement No. 157 to provide enhanced guidance for using fair value to measure assets and liabilities. This standard defines fair value and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances. FASB Statement No. 157 amends paragraph 11 of FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans, to change the definition of fair value.

.30 For plan assets and liabilities that are traded in active markets, fair value is determined based on quoted market prices. If quoted market prices for identical assets and liabilities are not available, the plan uses valuation techniques that should maximize the use of observable inputs (assumptions based on market data) and minimize the use of unobservable inputs. In measuring fair value, the plan should make adjustments for risks and uncertainties if a market participant would include such an adjustment in its pricing. FASB Statement No. 157 requires entities to make certain disclosures for each major category of assets and liabilities that are measured at fair value, including the level within the fair value hierarchy in which the fair value measurements fall as discussed in paragraphs 22–31 of the standard. Please refer to paragraphs 32–35 of the standard for disclosure requirements.

.31 FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. A contention with FASB Statement No. 157 is in regard to lack of guidance in applying fair value in an illiquid or distressed market, such as the current one. To respond to this concern, in October 2008, FASB issued FASB Staff Position (FSP) FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active, which clarifies FASB Statement No. 157's application in an inactive market and also amends the standard to include an illustrative example. In March 2009, FASB posted for comment, proposed FSP FAS 157-e, Determining Whether a Market Is Not Active.
and a Transaction Is Not Distressed, which would provide additional guidance on determining whether a market for a financial asset is not active and a transaction is not distressed for fair value measurements under FASB Statement No. 157. Readers can access the full text of FASB Statement No. 157 and the previously referenced FSPs and proposed FSP on the FASB Web site at www.fasb.org.

**Effect on Employee Benefit Plans and Plan Sponsors**

.32 Preparing to meet the requirements of FASB Statement No. 157 will require coordination among plan management, custodians, investment fiduciaries, and auditors. Generally accepted accounting principles (GAAP) require plan management to take responsibility for valuation and the Form 5500, Annual Return/Report of Employee Benefit Plan, requires assets to be reported at current value. Plan administrators have a fiduciary responsibility to ensure the accuracy of the information reported on the Form 5500. The nonauthoritative practice aid *Alternative Investments—Audit Considerations* states that “management of the investor entity is responsible for the valuation of alternative investment amounts as presented in the investor entity’s financial statements” and “this responsibility cannot, under any circumstances, be outsourced or assigned to a party outside of the investor entity’s management.” Therefore, plan management can delegate but not abdicate its valuation responsibility. Although the plan sponsor is responsible for establishing an accounting and financial reporting process for determining fair value measurements, the plan sponsor will typically rely on the trustee or custodian for the pricing of its investments. The trustee or custodian may use an outside service provider or pricing service for valuation of the investments. Because many plans outsource investment management activities to third party service providers, information regarding the pricing and valuation of the plan’s investments may not be fully transparent to those responsible for financial reporting.

.33 Plan management is ultimately responsible for the fair values reported in the financial statements and is obligated to carefully consider how third-party input is used in estimating fair value. Accordingly, plan management needs to understand and document the pricing inputs used by plan custodians and others used to value each plan investment in order to properly classify each investment into the appropriate level within the FASB Statement No. 157 hierarchy. Service providers are not typically making the hierarchy level decisions for plans. Plan management will need to obtain pricing service documentation describing the valuation methods they or their custodians use to support their fair value hierarchy. Pricing services typically used by plan trustees or custodians to provide investment prices, such as Interactive Data Pricing and Reference Data, have prepared this information.

.34 Accordingly, for full scope audits, auditors may consider the procedures and controls put in place by the plan sponsor and service provider to identify hard to value investments; validate the reliability of pricing or institute fair value procedures, or both, if necessary; monitor the collectability of accrued income; and modify reporting and disclosures based on the exposure of these markets in their plans. Auditors may also consider the need to enhance audit procedures to ascertain that prices obtained from pricing services are reasonable, including the use of multiple pricing sources or valuation experts to review any pricing models or fair value methodologies put in place, or both.

.35 Additional time may be needed this year to prepare and audit the investment information. Implementation issues will vary based on the types of investments held and the availability of information. Valuing different types of financial instruments, including understanding whether the valuation assumptions and methods used are appropriate under FASB Statement No. 157, and obtaining additional information about
valuation inputs to make the appropriate note disclosures may present plan sponsors and administrators with significant challenges.

| Help Desk—For audits of issuers, such as Form 11-K audits, the guidance in Public Company Accounting Oversight Board (PCAOB) Staff Audit Practice Alert No. 2, Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 400.02), would be applicable. |

.36 For limited scope audits, if the auditor becomes aware that the certified information relating to such investments is inaccurate as a result of valuation or other concerns, further inquiry may be necessary that might result in additional testing or modification to the auditor’s report. See the “Limited Scope Audits” section (paragraphs .52–.60) of this alert for further guidance.

.37 The AICPA Employee Benefit Plan Audit Quality Center (EBPAQC) has developed the following documents to assist readers, plan sponsors, and administrators with implementing FASB Statement No. 157:

- Getting Started: Applying New Accounting Rules for Measuring and Reporting Fair Value of Plan Investments
- Assessing the Fair Values of Your Plan Investments
- Alternative Investments in Employee Benefit Plans

Auditing Fair Value Measurements

.38 As was stated previously, it is plan management’s responsibility to make the fair value measurements and disclosures. When auditing these fair values to ensure they are in conformity with GAAP, auditors should consult AU section 328, Auditing Fair Value Measurements and Disclosures (AICPA, Professional Standards, vol. 1), which establishes standards and provides guidance for auditors. Specific types of fair value measurements are not covered by AU section 328. For example, when auditing the fair value of derivatives and securities, refer to AU section 332, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities (AICPA, Professional Standards, vol. 1).

.39 The strongest audit evidence to support a fair value is an observable market price in an active market. If that is not available, a valuation method may incorporate market assumptions. If market assumptions are not available or require significant adjustments, the entity may use its own assumptions. The auditor should obtain an understanding of the entity’s process for determining fair values, as well as whether the fair value measurements and disclosures are in accordance with GAAP. During this testing, the auditor also may identify possible indicators of impairment. According to paragraph .23 of AU section 328, “Substantive tests of the fair value measurements may involve (a) testing management’s significant assumptions, the valuation model, and the underlying data; (b) developing independent fair value estimates for corroborative purposes; or (c) reviewing subsequent events and transactions.” Paragraph .26 also notes when testing the fair value measurements and disclosures, the auditor evaluates whether management’s assumptions are reasonable and reflect market information, or are not consistent with market information. In relation to FASB Statement No. 157, this might include whether the market is distressed, whether the transaction was an orderly transaction, the reasonableness of the determination within the fair value hierarchy of inputs, and the reasonableness of the underlying assumptions.

.40 It is important for the auditor to be aware of the increased risk posed by current market conditions and to develop or modify audit procedures accordingly. Among other things, auditors may consider the following:

- The overall effect of risk on a plan’s portfolio of illiquid investments (for example, asset-backed commercial paper or high-yield debt or loans). The auditor should identify risks throughout the process of obtaining an understanding of the plan and its environment, including relevant controls.
such as controls at the plan sponsor and outside service provider, including any applicable investment service provider. The auditor also may consider the policies that affect the management and monitoring of these investments.

- The increased difficulty of obtaining reliable valuations for certain types of asset-backed securities, given the decrease in market liquidity. The auditor should obtain an understanding of the plan’s process for determining fair value measurements and disclosures and of the relevant controls sufficient to develop an effective audit approach. This would include controls over valuation at the plan sponsor and service provider, in particular the extent to which they monitor valuations obtained from brokers and external pricing services for consistency with observations of market conditions, as well as the involvement of valuation committees or other internal review groups independent of portfolio managers in assessing the day-to-day reasonableness of security valuations and overriding quotations that appear to be unrepresentative.

- Swap or derivative contracts are often written using the International Swap and Derivatives Association Master Agreement (ISDA) protocol. ISDA contracts include events of default and termination events, similar to bank loan covenants. The effect of a violation could be the acceleration or termination of the agreement, the requirement to post additional collateral, or the violation could effect the valuation of the derivative instrument. The auditor may obtain an understanding of management’s ongoing monitoring process. If the vehicle is no longer in compliance with the covenants, the auditor would assess the appropriate accounting and reporting implications, including AU section 341.

.41 In certain instances, the auditor may need special skills or knowledge to plan and perform auditing procedures for privately held employee stock ownership plans (ESOPs) or plans that hold alternative investments and subprime-mortgage-backed securities. AU section 332 states that for some derivatives and securities, GAAP may prescribe presentation and disclosure requirements. Furthermore, AU section 332 advises the auditor to consider the form, arrangement, and content of the financial statements (including the notes) when evaluating the adequacy of presentation and disclosure. Auditors may also consider using a specialist when determining how to audit a plan that includes hard to value investments. AU section 336, Using the Work of a Specialist (AICPA, Professional Standards, vol. 1), provides guidance on the use of a specialist during an engagement.

**Fair Value of Securities**

.42 The guidance in AU section 332 relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, some items of note exist for the auditor. As previously mentioned, quoted market prices in active markets are the best available audit evidence to support a fair value; however, when they are unavailable and the valuations of securities are obtained from a broker or dealer or another pricing service based on valuation models, it is important for the auditor to understand the underlying valuation method used (such as a cash flow projection). These valuations also may be based on quoted prices from an active market or other observable inputs that would be considered by the auditor when developing audit procedures.

.43 The process used by the pricing service to measure fair value should be evaluated to determine that the resulting measurement is in accordance with the requirements of FASB Statement No. 157. The auditor also may determine it is necessary to obtain quotes from more than one pricing source based on circumstances such as an existing relationship between the entity and the valuing entity, which could inhibit objective pricing or underlying valuation assumptions that are highly subjective. In the context of FASB Statement No. 157, quoted prices in active markets for identical assets or liabilities are considered level 1 inputs.

.44 When an entity performs its own valuation, value testing procedures for the auditor to consider include assessing the reasonableness, comparing the assumptions to industry reports or benchmarks, assessing the appropriateness of the model, calculating the value using his or her own model, and comparing the fair value with subsequent or recent transactions. Whether or not the inputs to the entity’s valuation model are observable or not determines their characterization as level 2 or level 3 inputs, respectively, within the FASB
Statement No. 157 fair value hierarchy. When extensive judgment is needed, consider using a specialist or refer to AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1). Additionally, when the underlying collateral of a security significantly contributes to its fair value and collectability of the security, evidence of the collateral also should be examined for existence, fair value, transferability, and the investor’s right to the collateral.

**Using the Work of a Specialist**

.45 It may be necessary to use a specialist (such as a securities valuation expert) to assist in auditing complex or subjective matters. Examples of matters in which an auditor may engage a specialist are valuation issues; reasonableness of determination of amounts derived from specialized techniques or models; or implementation of technical requirements, regulations, or legal documents. AU section 336 provides guidance to auditors in using specialists. The guidance in AU section 336 is applicable when the specialist is hired by management or if the auditor engages the specialist. However, if a specialist employed by the auditor’s firm participates in the audit, AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), is applicable rather than AU section 336.

.46 When using the work of a specialist, the auditor should evaluate the specialist’s professional qualifications, obtain an understanding of the nature of the work performed or to be performed, and evaluate the relationship of the specialist to the client in terms of objectivity. Although the appropriateness and reasonableness of the methods and assumptions employed by the specialist are his or her responsibility, the auditor should obtain an understanding of these qualities, test the underlying data provided to the specialist, and evaluate the specialist’s findings in the context of the audit and related assertions in the financial statements.

**Alternative Investments**

.47 The AICPA practice aid *Alternative Investments—Audit Considerations* is a useful tool for auditors that focuses on the existence and valuation assertions associated with alternative investments but also discusses general considerations pertaining to auditing alternative investments, management representations, disclosure of certain significant risks and uncertainties, and reporting. As defined in the foreword of the practice aid, alternative investments are “investments for which a readily determinable fair value does not exist...including private investment funds meeting the definition of an investment company...such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as bank common/collective trust funds.” You can access the full text of this practice aid on the AICPA’s Web site at www.aicpa.org/download/members/div/auditstd/Alternative_Investments_Practice_Aid.pdf.

.48 Further, as discussed in a meeting of FASB’s Valuation Resource Group, net asset value of a fund may not represent fair value under FASB Statement No. 157. Given the state of the economy, many funds are imposing limitations on redemptions and some are even unwinding. To assist with the estimation of fair value of interests in alternative investments, the Accounting Standards Executive Committee (AcSEC) of the AICPA has issued the draft issues paper *FASB Statement No. 157 Valuation Considerations for Interests in Alternative Investments*. The draft issues paper discusses how to estimate the fair value of alternative investments (such as interests in hedge funds, private equity funds, or real estate funds) in accordance with the provisions of FASB Statement No. 157. Among other things, the draft issues paper discusses the role of net asset value (NAV) in estimating fair value. The draft issues paper can be found at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/AcSEC+Issues+Draft+Issues+Paper+on+Valuation+of+Interests+in+Alternative+Investments.htm.

.49 The following is a list of additional resources that provides guidance on auditing investments:

- AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1)
Master Trust Fair Value Disclosures

AICPA Issues Technical Practice Aid

The AICPA recently issued an employee benefit plan related Technical Practice Aid (TPA) to provide guidance on the required fair value measurement disclosures to be made when a plan holds investments in a master trust. Technical Questions and Answers (TIS) section 6931.11, “Fair Value Measurement Disclosures for Master Trusts” (AICPA, Technical Practice Aids), is available on the AICPA’s Web site www.aicpa.org and is also provided in the following section.

Fair Value Measurement Disclosures for Master Trusts

Inquiry—Employee benefit plans often hold investments under master trust arrangements. According to the Department of Labor’s Form 5500 instructions, a master trust is a trust for which a regulated financial institution serves as trustee or custodian and in which assets of more than one plan, sponsored by a single employer or by a group of employers under common control, are held.

In a typical master trust arrangement, the plan does not hold units or shares of the master trust but has an undivided interest in the assets of the master trust. However, for participant directed defined contribution plans, the plan typically has a divided interest in the individual assets of the master trust based upon participant direction. The “Additional Financial Statement Disclosures” section in chapters 2 and 3 of the AICPA Audit and Accounting Guide Employee Benefit Plans (guide) requires investments in master trusts to be shown as a single line item on the statement of net assets available for benefits; however, the plan does not “purchase” and “dispose” of its interest in the master trust but is allocated an interest once the plan sponsor chooses to transfer the plan’s assets into the master trust. The guide also requires the master trust investments to be shown by general type in the footnotes.

For employee benefit plan financial statements, are the disclosure requirements of paragraphs 32–34 of Financial Accounting Standards Board (FASB) Statement No. 157, Fair Value Measurements, required for the plan’s total interest in the master trust or the individual investments under the master trust arrangement?

Reply—The disclosures required by paragraphs 32–34 of FASB Statement No. 157 are required for individual investments under a master trust arrangement and are not required for the plan’s total interest in the master trust.

According to paragraph 32 of FASB Statement No. 157, for assets that are measured at fair value on a recurring basis in periods subsequent to initial recognition, the reporting entity shall disclose information that enables
users of its financial statements to assess the inputs used to develop those measurements, and for recurring
fair value measurements using significant unobservable inputs (level 3), the effect of the measurements on
earnings (or changes in net assets) for the period.

Because of the nature of the plan’s ownership interest in the master trust—that is, the plan does not hold units
or shares of a master trust—FASB Statement No. 157 disclosures should be presented for the underlying
master trust investments. Therefore, the plan should disclose separately the following information for each
period for each major category of master trust assets and liabilities (quantitative disclosures should be made
in tabular format):

a. The fair value measurements recorded during the period and the reasons for the measurements
b. The level within the fair value hierarchy in which the fair value measurements in their entirety fall,
   segregating fair value measurements using quoted prices in active markets for identical assets or
   liabilities (level 1), significant other observable inputs (level 2), and significant unobservable inputs
   (level 3)
c. For fair value measurements using significant unobservable inputs (level 3), a description of the
   inputs and the information used to develop the inputs
d. In annual periods only, the valuation technique(s) used to measure fair value and a discussion of
   changes, if any, in the valuation technique(s) used to measure similar assets or liabilities, or both, in
   prior periods.

Consideration should be given to combining, or reconciling, or both, the master trust FASB Statement No. 157
disclosures as described previously with the current master trust disclosures as required in chapters 2 and 3
of the guide.

Limited Scope Audits

.52 When a plan administrator elects to have a limited scope audit performed, the auditor is instructed by
the plan administrator to limit the scope of testing on investment information prepared and certified by a
qualified trustee or custodian as complete and accurate. The trustee or custodian certifies to the “completeness
and accuracy” of the plan’s investment assets and investment activity as contained in the institution’s ordinary
books and records, which may or may not be fair value in accordance with GAAP. Although DOL regulations
allow the qualified trustee or custodian to report in this manner, it is the plan sponsor’s responsibility to
prepare the financial statements and footnote disclosures in accordance with GAAP (that is, at fair value as
of the plan’s year-end).

Practice Tip: Plan administrators should review their trustee or custodial arrangements to
determine the nature of the financial information that will be provided by the trustee or
custodian, or both. For instance, in cases where the plan invests in assets without readily
determinable market values, the reported values may be based on the best information
available to the trustee or custodian at the time the certification is prepared, which may
or may not be fair value as of the plan’s year end.

.53 The auditor’s responsibilities for investments covered by the limited scope exemption are to (a) obtain
and read a copy of the certification from the plan administrator, (b) determine whether the entity issuing the
certification is a qualifying institution under DOL regulations, (c) compare the certified investment informa-
tion to the financial statements and related disclosures, (d) perform the necessary procedures to become
satisfied that any received or disbursed amounts reported by the trustee or custodian were determined in
accordance with the plan provisions, and (e) determine whether the form and content of the financial
statement disclosures related to the investment information prepared and certified by the plan’s trustee or
custodian are in conformity with GAAP and are in compliance with DOL rules and regulations. See
paragraphs 7.65–69 of AICPA Audit and Accounting Guide Employee Benefits Plans for further guidance on
limited scope audits.
The scope limitation extends only to investments and related investment information certified by the qualified trustee or custodian. Plan investments not held by a qualified trustee or custodian, such as real estate, leases, mortgages, self-directed brokerage accounts, participant loans, and any other investments or assets not covered by such a certification, should be subjected to appropriate audit procedures. Moreover, the appropriate audit procedures for all noninvestment related information (for example, contributions and distributions) are the same for a limited scope audit as they are for a full scope audit.

When engaged to perform a limited scope audit, the auditor has no responsibility to perform audit procedures on investments and related activity covered by the certification. Although the auditor is not required to audit certain investment information when the limited scope audit exception is applicable, if the auditor becomes aware that the certified information is incomplete, inaccurate, or otherwise unsatisfactory, further inquiry may be necessary that might result in additional testing or modification to the auditor’s report. In certain instances, a limited scope audit may no longer be appropriate (or may only be appropriate with respect to certain investments held by the plan).

Plan management’s decision to rely on a certification for purposes of limiting the scope of the audit has become increasingly more challenging, especially in light of recent economic events as well as the issuance of FASB Statement No. 157. Because plans increasingly invest in alternative investments (including hedge funds, real estate, limited partnerships, private equity funds, and other hard-to-value investments), care should be taken by plan management when determining if certified information can be relied upon in preparing the plan’s Form 5500 and related financial statements.

Plan management will need to have sufficient understanding of the nature of the plan’s investments and the valuation methodologies, key assumptions, and inputs used to determine fair value. Plan management cannot outsource or assign its responsibility for properly reporting fair value of the plan’s investments, even in situations where the plan’s trustee or custodian certifies the completeness and accuracy of the plan’s investments for a limited scope audit. Therefore, prior to being engaged to perform a limited scope audit, it is recommended that plan management and the auditor briefly discuss the nature of the investments held by the plan, including how those investments are valued and where they fall in the fair value hierarchy, to help ensure that plan management engages their auditor to perform the appropriate type of audit.

Practice Tip: FASB Statement No. 157 does not change the auditor’s responsibility in a limited scope audit. Third parties may provide pricing methodology information that assists plan management in determining the fair value hierarchy levels, or may provide preliminary suggestions of the fair value hierarchy levels. It is ultimately the responsibility of the plan’s management to understand the basis for the designations to determine whether the plan’s investments have been valued and disclosed in accordance with GAAP or whether revisions are necessary.

If the auditor becomes aware that the certified information relating to such investments is inaccurate as a result of valuation or other concerns, further inquiry may be necessary that might result in additional testing or modification to the auditor’s report. For example, when a plan has significant interests in alternative investments, that are hard to value or fall within level 3 of the fair value hierarchy, this may prompt the auditor to inquire whether these investments are covered by the certification, the method used to value these investments, and whether they are reflected in the certification at fair value in accordance with GAAP. Upon further inquiry, if the auditor becomes aware that adequate year-end valuation procedures have not been performed and therefore the financial statements may not be prepared in conformity with GAAP, the auditor would communicate those findings to the plan management. It is the plan management’s responsibility to prepare the financial statements and footnote disclosures in conformity with GAAP and in compliance with DOL rules and regulations. Accordingly, plan management may request the trustee or custodian to recertify or amend the certification for such investments at their appropriate year-end values or to exclude such investments from the certification. If the trustee or custodian amends the certification to exclude such investments from the certification, or if the trustee or custodian does not recertify those investments, plan management is responsible for valuing such investments as of the plan year-end and engaging the auditor.
to perform full scope audit procedures on the investments excluded from the certification. Paragraph 7.69 of Audit and Accounting Guide Employee Benefit Plans contains an illustrative auditor’s report when plan investments have been certified and plan management was unable to determine whether the investment information is valued in conformity with GAAP.

.59 If the trustee or custodian excludes certain investments from the certification, this ordinarily would not affect the limited scope language in the auditor’s report. Accordingly, the footnote pertaining to certified information should only reflect the investment information that was included or derived from the certified information.

.60 In the event that the audit changes from a limited scope in the prior year to a full scope in the current year, the auditor would perform full scope audit procedures regarding the beginning balances of investments. See paragraph 13.28 of Audit and Accounting Guide Employee Benefit Plans for an illustrative auditor’s report when the scope of the audit in the prior year was limited in accordance with DOL rules and regulations.

**Practice Tip:** After the issuance of the auditor’s report, if the auditor subsequently discovers that certain or all investment information should have been subjected to full scope audit procedures in the prior year, the auditor may be required to perform additional procedures and to consider whether to recall, restate, or reissue the prior auditor’s report. For further guidance, refer to AU section 390, Consideration of Omitted Procedures After the Report Date, and AU section 561, Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report (AICPA, Professional Standards, vol. 1).

### Stable Value Funds

.61 Some employer-sponsored defined contribution plans offer an investment alternative often referred to as a stable value fund. These funds primarily invest in guaranteed investment contracts (GICs) issued by insurance companies and other financial services institutions, referred to as **traditional GICs** and **synthetic GICs**. Synthetic contracts often invest in mortgage related fixed income investments. FSP AAG INV-1 and SOP 94-4-1, Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans, allows such contracts to be presented at contract value for purposes of determining the net assets available for benefits for a defined-contribution plan if the contract meets the definition of benefit responsiveness according to the FSP. An investment contract is considered fully benefit-responsive for purposes of the FSP, if all of the following criteria are met for that contract:

- The investment contract is effected directly between the plan and the issuer and prohibits the plan from assigning or selling the contract or its proceeds to another party without the consent of the issuer.

- Either (a) the repayment of principal and interest credited to participants in the plan is a financial obligation of the issuer of the investment contract or (b) prospective interest crediting rate adjustments are provided to participants in the plan on a designated pool of investments held by the plan or the contract issuer, whereby a financially responsible third party, through a contract generally referred to as a wrapper, must provide assurance that the adjustments to the interest crediting rate will not result in a future interest crediting rate that is less than zero. If an event has occurred such that realization of full contract value for a particular investment contract is no longer probable (for example, a significant decline in creditworthiness of the contract issuer or wrapper provider), the investment contract shall no longer be considered fully benefit-responsive.

- The terms of the investment contract require all permitted participant-initiated transactions with the plan to occur at contract value with no conditions, limits, or restrictions. Permitted participant-initiated transactions are those transactions allowed by the plan, such as withdrawals for benefits, loans, or transfers to other funds within the plan.
• An event that limits the ability of the plan to transact at contract value with the issuer (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives) that also limits the ability of the plan to transact at contract value with the participants in the plan must be probable of not occurring.

• The plan itself must allow participants reasonable access to their funds.

.62 As a result of recent credit market events, some of the issuers of these contracts may have experienced a decline in credit worthiness. In addition, as a result of depreciation in the mortgage back securities and related markets, the difference between fair value and contract value for synthetic GIC contracts has increased risk relating to these contracts. Certain issuers are requesting to terminate contracts, limit future contributions or redemptions, or increase wrap fees. In addition, certain issuers are deciding to no longer offer stable value products or exiting the business altogether thereby limiting the number of stable value alternatives for plan sponsors. Also, these contracts typically have certain investment guidelines that need to be followed in order to maintain the stable value protection by the wrap provider.

.63 Reading stable value contracts would enable auditors to understand the terms for (a) events that limit the ability of the plan to transact at contract value with the issuer (for example, premature termination of the contracts by the fund, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives), and (b) events and circumstances that would allow issuers to terminate fully benefit-responsive investment contracts with the fund and settle at an amount different from contract value (for example, breaches of investment guidelines, investments in default, and so on). For appropriate financial statement accounting and reporting, it is important for the auditor to give careful consideration to the ability of the issuer to comply with the terms of the contracts, the benefit-responsive provisions of the FSP, and the credit worthiness of the wrap provider.

.64 Plans may hold stable value investments through direct contracts with issuers or through a separately managed account. Plans may also hold stable value investments through beneficial ownership of bank collective funds (CCTs) that own investment contracts. Insurance company pooled separate accounts that hold investment contracts also have similar characteristics. See TIS section 6931.08, “Types of Investments Subject to SOP 94-4, as Amended by FSP AAG INV-1 and SOP 94-4-1” (AICPA, Technical Practice Aids), for further guidance that includes financial statement presentation and disclosure guidance for CCTs and master trusts.

Going Concern Matters

.65 Many plan sponsors are currently experiencing, or may experience in the near term, conditions and events that may raise substantial doubt about their ability to continue as a going concern for a reasonable period of time (not to exceed one year beyond the date of the financial statements being audited). Substantial doubt raised about the plan sponsor may also raise concerns about the ability of the plan to continue as a going concern. Given the current volatile economic environment, management’s evaluation of the plan’s ability to continue as a going concern for a reasonable period of time may require more extensive analysis. It may be necessary for the auditor to obtain additional information about such conditions and events, as well as the appropriate audit evidence to support information that mitigates the auditor’s doubt.

.66 If the auditor believes there is substantial doubt about the plan’s ability to continue as a going concern for a reasonable period of time, he should (a) obtain information about management’s plans that are intended to mitigate the effect of such conditions or events, and (b) assess the likelihood that such plans can be effectively implemented. The assessment of the plan’s ability to continue as a going concern is the responsibility of the plan’s management. The auditor’s responsibility, as described in AU section 341 is to consider, when planning and performing audit procedures and evaluating their results, the appropriateness of management’s use of the going concern assumption in the preparation of the financial statements.

.67 Additionally, current market conditions have heightened the expectations of financial statement users that entities, including benefit plans, will be providing a more thorough and transparent analysis of risks and uncertainties in accordance with SOP 94-6, which requires management to make certain disclosures of risks and uncertainties facing the entity. In many cases, those are the same risks and uncertainties that management
and the auditor need to assess in evaluating the entity’s ability to continue as a going concern. It is important for the auditor to have discussions with management about the plan’s significant risks and uncertainties and the adequacy of disclosures about them in current year financial statements.

.68 Conditions or events that raise doubt about the plan sponsor’s ability to continue as a going concern are significant in evaluating the ability of an employee benefit plan to continue as a going concern for a reasonable period of time. Factors that may be relevant to management’s use of the going concern assumption or, conversely, events or conditions that may cast substantial doubt on the going concern assumption include, but are not limited to, financial events that are becoming more prevalent in the current environment, such as the following:

- Substantial doubt about the plan sponsor’s ability to continue as a going concern
- The ability of the plan sponsor to continue funding the plan
- The plan’s lack of liquidity
- The plan’s ability to continue paying benefits when due to participants

.69 For defined contribution plans, the financial condition of the plan sponsor typically does not affect the plans’ ability to meet its obligations as they become due; however, consideration should be given to the level of company stock held by the plan, restrictions on withdrawals from certain investments held by the plan due to liquidity concerns, and plan terminations (see paragraphs 3.36–.39 of Audit and Accounting Guide Employee Benefit Plans for guidance regarding terminating plans).

.70 After the auditor has evaluated management’s plans, the auditor concludes whether he or she has substantial doubt about the plan’s ability to continue as a going concern for a reasonable period of time. If the auditor concludes there is substantial doubt, the auditor should (a) consider the adequacy of disclosure about the plan’s possible inability to continue as a going concern for a reasonable period of time, and (b) include an explanatory paragraph (following the opinion paragraph) in his audit report to reflect his conclusion. If the auditor concludes that substantial doubt does not exist, he or she should consider the need for disclosure. When, primarily because of the auditor’s consideration of management’s plans, he or she concludes that substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time is alleviated, the auditor should consider the need for disclosure of the principal conditions and events that initially caused him or her to believe there was substantial doubt. The auditor’s consideration of disclosure should include the possible effects of such conditions and events, and any mitigating factors, including management’s plans.

ERISA-Covered 403(b) Employee Benefit Plans

.71 Section 403(b) plans are also commonly known as tax-sheltered annuity plans (TSA plans). A 403(b) TSA plan is a retirement plan offered by schools, hospitals, churches, charities, and certain other tax-exempt organizations. An individual’s 403(b) annuity can be obtained only under an employer’s TSA plan. Generally, these annuities are funded by elective deferrals made under salary reduction agreements and may include nonelective employer contributions. A 403(b) plan works very similarly to a 401(k) plan.

.72 A 403(b) plan comprises individual investment accounts that may include the following types:

- Fixed and variable annuity contracts with insurance companies—403(b)(1) annuities
- Custodial accounts made up of mutual funds—403(b)(7) accounts
- A retirement income account set up for church employees—403(b)(9) accounts

New IRS Regulation Highlights

.73 On July 23, 2007, the IRS issued the first comprehensive regulations for 403(b) plans in 43 years. The IRS's new rules bring 403(b) plans closer to the standards set for 401(k) plans and may result in significant changes for tax-exempt organizations and their employees. The new IRS regulations clarify several points on
employer responsibility and require all organizations to have a written plan document in place. Additionally, in an effort to ease the administrative burden, the new IRS rules have the effect of encouraging employers to limit the number of investment vendors offered to employees while introducing due-diligence expectations that affect daily plan management. The new IRS rules were effective for 403(b) plan years beginning on or after January 1, 2009; however, the IRS provided some relief to the written plan document requirement when they issued IRS Notice 2009-3, Relief From Immediate Compliance With 2009 § 403(b) Written Plan Requirement, indicating they will treat plans as meeting the requirements of 403(b) and the regulations during the 2009 calendar year if

- by December 31, 2009, the plan sponsor has adopted a written 403(b) plan that is intended to satisfy the requirements of 403(b) and the regulations;
- during 2009, the plan sponsor operates the plan in accordance with a reasonable interpretation of 403(b) and the related regulations; and
- by the end of 2009, the plan sponsor makes its best effort to retroactively correct any operational failure during the 2009 calendar year to conform to the written plan.

New Filing and Audit Requirements for ERISA-Covered 403(b) Plans

.74 On November 16, 2007, the Employee Benefits Security Administration (EBSA), the IRS, and the Pension Benefit Guaranty Corporation (PBGC) published in the Federal Register revisions to the Form 5500 for plan year 2009. The revisions include improved financial disclosure by the approximately 16,000 403(b) TSA plans subject to Title I of the Employee Retirement Income Security Act of 1974 (ERISA) by making the reporting rules for those 403(b) plans on par with 401(k) plans. A 403(b) plan generally will be covered under ERISA if there are employer contributions or employer involvement in the plan exceeds the limitations permitted under the DOL’s safe harbor regulations, or both. (For further information, see DOL Field Assistance Bulletin No. 2007-02 online at www.dol.gov/ebsa/regs/fab2007-2.html.)

.75 Beginning with 2009 Form 5500 filings, employee benefit plans under Section 403(b) of the IRC covered under ERISA that are sponsored by charitable organizations will be subject to the same Form 5500 reporting and audit requirements that currently exist for Section 401(k) plans. The new DOL amended regulations eliminated a previous exemption granted to IRC Section 403(b) plans from the annual Form 5500 reporting, disclosure, and audit requirements under Part 1 of Subtitle B of Title I of ERISA. Generally, 403(b) plans sponsored by charities and schools are subject to ERISA whereas 403(b) plans sponsored by religious organizations and governments are not covered under ERISA.

.76 For large 403(b) plans (generally plans with 100 or more eligible participants at the beginning of the plan year), the new reporting requirements include not only the completion of the entire Form 5500, but also the engagement of an independent qualified public accountant (IQPA) to conduct an independent audit of the plan.

.77 The 2009 Form 5500 package and the related Federal Register notices are available on the EBSA’s Web site at www.dol.gov/ebsa.

First Year Auditing Considerations for 403(b) Plans

.78 Although the new, large-plan audit requirement will not be in effect until the 2009 plan year, ERISA requires the presentation of comparative statements of net assets. As such, when a plan’s financial statements have not been previously audited, the auditor should apply procedures to assure himself that the accounting principles used by the plan in both the current and preceding year are consistent. (See paragraphs .24–.25 of AU section 420, Consistency of Application of Generally Accepted Accounting Principles [AICPA, Professional Standards, vol. 1], for further guidance.) The initial audit of the plan will likely require significant audit effort as the auditor will need to perform procedures to test the completeness and accuracy of plan and participant-level information going back numerous years.
Many plans may face significant challenges in establishing plan accounting records and proper controls, such as identifying all participant accounts to be included as plan assets, determining beginning account balances (that is, comparative balances are also required as of December 31, 2008, for calendar year plans), and obtaining other financial information to be included in the plan’s financial statements, which could hinder an auditor’s capability of issuing an unqualified opinion on the plan’s financial statements. For example, plans may have multiple third-party administrator (TPA) vendors (nonexclusive administration), orphan contracts (old accounts and contracts that were not transferred to the current TPA), missing participants, or participants with multiple annuity contracts. Also, historical plan records may not be readily available or may be nonexistent for previous years.

For many 403(b) plans, the individual account plan status goes further than what auditors may be accustomed to seeing. The assets attributable to a participant’s vested interest may be held in a custodial account or in an annuity contract that is issued in the participant’s name, rather than the plan’s name. This industry practice raises critical plan reporting issues and associated audit issues including the following questions:

- What are the plan’s assets?
- When does a terminated employee cease to be a plan participant?
- Does the plan report distributions?

During this transition period, it is important for auditors to work with their clients to determine the kind of contracts held by the plan and the ownership of those contracts.

Areas of special consideration in an initial audit of a plan’s financial statements include (a) the completeness of participant data and records of the prior year(s), especially as they relate to participant eligibility; (b) the amounts and types of benefits; (c) the eligibility for benefits; and (d) account balances.

The nature, timing, and extent of auditing procedures applied by the auditor are a matter of judgment and will vary with factors such as the adequacy of past records, the significance of beginning balances, the complexity of the plan’s operations, and controls covered by Statement on Auditing Standards (SAS) No. 70, Service Organizations (AICPA, Professional Standards, vol. 1, AU sec. 324), reports.

Because ERISA requires that audited plan financial statements present comparative statements of net assets available for benefits, the current year statements should be audited, and the prior year that is presented for comparative purposes may be either compiled, reviewed, or audited. Appropriate reference in the current year audit report should be made to describe the level of responsibility assumed in the prior year. However, although a compilation or review of prior year is acceptable, the auditor would apply sufficient auditing procedures on the beginning balance of net assets available for benefits to obtain appropriate evidence that no material misstatements to these beginning balances exist that may affect the current year’s statement of changes in net assets available for benefits.

The DOL intends to fully enforce this new audit requirement. Accordingly, it is critical that plan auditors educate themselves and their clients about this change and its effects on plan records that will be subject to audit. Auditors should carefully consider whether to accept the audit of a 403(b) plan. For example, they should consider

- independence under the DOL and AICPA independence standards (for example, has the auditor provided management functions or other nonaudit services to help prepare the plan for audit such that independence may be impaired?); and
• risks associated with the engagement and if they have the requisite skills and competence to complete
the engagement (see the “Client Acceptance and Continuance” section that follows for further
information).

Help Desk—The EBPAQC has created a 403(b) Resource Center at the EBPAQC Web site
www.aicpa.org/EBPAQC (under the “Resources” tab), which has helpful resources and
links to additional information to help practitioners with the new requirements.

Client Acceptance and Continuance Considerations

.86 Statement on Quality Control Standards No. 7, A Firm’s System of Quality Control (AICPA, Professional
Standards, vol. 2, QC sec. 10 par. .27), provides that policies and procedures should be established for the
acceptance and continuance of client relationships and specific engagements. Such policies and procedures
should provide the audit firm with reasonable assurance that it will undertake or continue relationships and
engagements only where the firm

• has considered the integrity of the client, including the identity and business reputation of the client’s
principal owners, key management, related parties, and those charged with its governance, and the
risks associated with providing professional services in the particular circumstances;

• is competent to perform the engagement and has the capabilities and resources to do so; and

• can comply with legal and ethical requirements.

.87 The firm should obtain such information as it considers necessary in the circumstances before accepting
an engagement with a new client, when deciding whether to continue an existing engagement, and when
considering acceptance of a new engagement with an existing client.

.88 The following is a list of risk factors that engagement teams might consider during their client
acceptance and continuance discussions related to an employee benefit plan engagement:

• Ineffective monitoring by management (for example, lack of oversight by plan management of
outside providers [such as lack of review of reconciliations of trust assets to participant accounts or
no independent records maintained by the sponsor to periodically check information provided by the
custodian] or an ineffective plan oversight committee)

• Complex or unstable organizational structure (for example, turnover of plan management, oversight
committee members, or outside service providers or difficulty in determining what individuals or
committees have oversight or fiduciary responsibility for the plan)

• Weak financial reporting skills, failure by the plan administrator or plan management to take
appropriate responsibility for the financial statements, or the plan has a material weakness or
significant deficiency in its financial reporting process

• Significant related party transactions or transactions with parties in interest, or history of engaging
in prohibited transactions (for example, involvement in nonexempt transactions or events or activities
[violations of laws, regulations, or plan provisions] that could cause loss of tax-exempt status)

• Plan invests in nonreadily marketable securities (such as limited partnerships and nonpublicly traded
employer securities), specialized, or unique investments, or engages in securities lending (regardless
of the scope of the audit) and management lacks the proper oversight and understanding of such
investments, including valuation

• The use of service providers that do not provide a type 2 SAS No. 70 report

• The plan is inherently more complex (such as, health and welfare plans and leveraged ESOPs) and
the engagement team lacks the technical skills that are necessary to audit such a plan
• Other inherent risk factors, such as electronic payroll or human resources systems, complex-decentralized control environment, or in-house processing of complex transactions (such as benefit calculations and claims)
• The plan has significant issues with regulatory agencies, pending enforcement matters, or other investigations

The Pension Protection Act and Other 2008 Legislation

Effects of the Pension Protection Act on Defined Benefit Plans

.89 The Pension Protection Act (PPA) has affected many aspects of plan design, administration, and funding. For defined benefit plans, the PPA focuses on the funded percentage as the trigger point to activate additional funding requirements and benefit limitations. These rules are very complex and this discussion will not address all of those complexities but rather will provide an overview of the key features.

.90 New minimum funding standards were fully operational for 2008 plan years. Minimum funding standards are established based on a plan’s funded status. The funding target is the present value of accrued benefits. If the assets equal the present value of accrued benefits, the plan’s funding target percentage will be 100 percent. The minimum required contribution for plans with a funded percentage of 100 percent or greater will be the plan’s normal cost. This is the actuarially determined amount necessary to fund the benefits that have accrued in the current year. For plans with a funded percentage of less than 100 percent, the minimum required contribution will be the plan’s normal cost plus an additional payment that will amortize the shortfall over 7 years. Funding waivers may be requested in cases of business hardship. As in prior years, the minimum required contribution will be part of the actuarial report.

.91 Each year the actuary is required to certify to the plan’s funded percentage. Plans with a funding percentage below 80 percent will be required to implement certain benefit limitations. Further limitations will be required when the percentage falls below 60 percent. Plans with a funded percentage more than 60 percent but less than 80 percent may not amend the plan to provide additional or increased benefits. They must also place a limit on accelerated benefits such as lump sums and annuity purchases. This limit is 50 percent of the full amount allowed by the plan. If the funded percentage falls below 60 percent, the plan must freeze the accrual of all future benefits until such time as the percentage increases to more than 60 percent. The plan will also not be allowed to make any accelerated payments. The auditor will need to determine if the plan is being operated in accordance with any limitations that apply based on these rules.

Automatic Enrollment and Planning Considerations

.92 There has been a significant increase in the number of plan sponsors choosing to automatically enroll plan participants largely because the PPA included provisions designed to encourage sponsors of 401(k) plans to add an automatic enrollment feature.

.93 Automatic enrollment is a mechanism where an eligible employee who does not make an affirmative election to make pretax contributions to the plan is automatically enrolled in the plan at a specific pretax contribution percentage, unless the employee specifically opts out. Because those funds must then be invested, the PPA also included provisions to protect plan fiduciaries that invest a participant’s account in certain default investment options. The IRS issued proposed regulations regarding the implementation of automatic contribution arrangements, and the DOL issued final regulations regarding default investments.

.94 On October 24, 2007, the DOL published a final rule in the Federal Register establishing qualified default investment alternatives (QDIA), making it easier for employers to automatically enroll workers in their 401(k) and other defined contribution plans. Auditors may want to consider any amendments made to the plan document as a result of the PPA provisions when determining the audit approach.
The IRS issued proposed regulations in November 2007 to implement automatic enrollment. The proposed regulations describe 2 types of automatic enrollment arrangements: an eligible automatic contribution arrangement and a more complex qualified automatic contribution arrangement that passes certain nondiscrimination rules automatically.

The final regulation does not identify specific investment products. Rather, it describes mechanisms for investing participant contributions. The intent is to ensure that an investment qualifying as a QDIA is appropriate as a single investment capable of meeting a worker’s long term retirement savings needs.

It is important for auditors to be aware of the rules governing an employee’s right to withdraw from the plan following his or her automatic enrollment. An eligible automatic contribution arrangement may allow employees to elect permissible withdrawals of amounts that were automatically contributed to the plan on behalf of the employee. To be effective, the election must be made within 90 days after the date of the first automatic contribution made for the employee under the arrangement. This distribution is permissible in spite of the normal 401(k) plan restrictions on in-service distributions. If the plan wants to include this privilege, which is very popular as it eliminates the accounting for very small balances, the plan must provide for this privilege. In addition, the plan must provide participants with a notice describing this right upon initial enrollment in the plan and at least annually thereafter.

Because of the current economic conditions, more and more plans may be faced with employees electing out of plan participation and wanting their money back. A significant risk of an operational error exists in the implementation of this new rule. A copy of the regulation and a fact sheet detailing the rule may be found at the DOL’s Web site at www.dol.gov/ebsa/regs.

COBRA Premium Assistance Under the ARRA

The Consolidated Omnibus Budget Reconciliation Act (COBRA) provides employees and their dependents with the right to continue access to certain types of healthcare coverage once eligibility is otherwise terminated for a variety of reasons. A new subsidy for COBRA premiums has been provided under the ARRA. In tough economic times, many employees are losing their healthcare coverage and they find that they cannot afford the cost of coverage under COBRA. The ARRA will subsidize 65 percent of this coverage for eligible persons. An eligible person is someone who involuntarily lost his or her job between September 1, 2008, and December 31, 2009. A new COBRA election period must be made available for persons who were terminated prior to the effective date of the legislation and whose normal COBRA election period has expired and for those who had elected coverage but subsequently lost coverage due to inability to pay.

Employers can recover this cost through a credit to their payroll taxes. This first applies to coverage period beginning on or after February 17, 2009. For welfare benefit plans subject to audit, this law change presents interesting financial reporting issues which could effect the post employment benefit obligation at the plan level. The employee pays only a portion of the premium while the plan pays the full benefit, but the employer’s reimbursement for its share of the costs is recorded as a reduction in the employer’s obligation for payroll taxes. The Form 941, Employer’s Quarterly Federal Tax Return, instructions explain how to complete lines 12a and 12b, which address the COBRA premium assistance payments.

For a summary of the law change, see www.dol.gov/ebsa/newsroom/fsCOBRApremiumreduction.html. This law change may affect the measurement of benefit obligations for health and welfare plans.

Audit and Accounting Guide Revision as of March 1, 2009

Audit and Accounting Guide Employee Benefit Plans has been updated with conforming changes as of March 1, 2009, and includes updates required by FASB Accounting Standards Codification™ (ASC). The Audit
Audit and Attestation Issues and Developments

SAS No. 70 Issues

.103 Internal control of a benefit plan consists of the controls at the sponsor as well as the controls at applicable service and subservice organizations that perform significant plan functions including but not limited to processing of participant-level transactions such as contributions and distributions, investment custody and valuation, and execution of investment transactions. A report prepared in accordance with SAS No. 70, as amended, may be useful in providing user auditors with a sufficient understanding of controls at the service organization to assess the risks of material misstatement in accordance with AU section 314.

.104 It is not uncommon for the service organization’s SAS No. 70 report to cover only some of the services used by the plan (for example, the report might cover custodial services but not allocation services) or to not cover activities performed by subservice organizations (for example, the report might not cover services performed by an investment pricing service). The subservice organization may be a separate entity from the service organization or may be related to the service organization. For example, 401(k) record keepers often exclude the related data processing center from their SAS No. 70 reports. The independent auditor’s report included in the SAS No. 70 report will typically include language that the report does not cover certain significant service or subservice organizations or systems. For less significant service or subservice organizations or systems, this language will not be included in the auditor’s report, but will be described elsewhere in the report. In these situations, auditors would gain an understanding of the controls related to the services not covered in the SAS No. 70 report as they relate to the plan’s transactions processed by the service or subservice organization that are part of the plan’s information system. If the user auditor does not have sufficient information to assess control risk as low or moderate, the plan auditor may decide to perform additional tests of the service or subservice organization’s controls or perform additional audit procedures on the plan’s financial statements. The auditor may obtain a copy of the subservice organization’s SAS No. 70 report if one was issued.

.105 During 2008, the Auditing Standards Board (ASB) proposed two exposure drafts that related to SAS No. 70. First, the proposed SAS Audit Considerations Relating to an Entity Using a Service Organization (Redrafted) would supersede SAS No. 70. Currently, SAS No. 70 contains guidance for auditors auditing the financial statements of entities that use a service organization (user auditors) and for auditors reporting on controls at a service organization (service auditors). The proposed SAS will only contain guidance for user auditors. Guidance for service auditors will be contained in the new Statement on Standards for Attestation Engagements (SSAE) Reporting on Controls at a Service Organization that is being exposed for comment concurrently with the proposed SAS. The comment period for both exposure drafts ended February 17, 2009.

.106 See chapter 6, “Internal Control,” in the Audit and Accounting Guide Employee Benefit Plans for further guidance regarding SAS No. 70.

Auditing Plan Fees and Expenses

.107 Administrative expenses are often paid out of plan assets. As plan sponsors look for ways to decrease operating costs, it is becoming more common to amend benefit plans to allow for the payment of the expenses out of the plan. In certain instances, forfeitures are used to pay plan expenses. The auditor’s responsibilities with respect to testing administrative expenses are detailed in paragraphs 12.13–.14 of Audit and Accounting...
Guide Employee Benefit Plans. Auditors need to gain an understanding of the expenses that are allowed to be paid by the plan according to the plan document. Typically, plan expenses are below materiality levels in a benefit plan audit and, therefore, are not subject to significant detailed testing. Often, auditors obtain reasonable assurance related to expense balances using other audit procedures such as substantive analytics. Auditors may also want to be aware of fees paid by one plan on behalf of another plan resulting from errors or inappropriate allocations or fees paid by the plan for certain services (actuarial fees) that may relate to services provided to the plan sponsor. Excessive fees or expenses paid by the plan that are not allowed by the plan document, no matter how immaterial, may be deemed a prohibited transaction requiring further testing and disclosure as described in paragraph 11.13 of Audit and Accounting Guide Employee Benefit Plans.

.108 In addition, any fees or expenses paid to related parties need to be considered for disclosure under FASB Statement No. 57, Related Party Disclosures. In certain instances, it may be difficult to understand the nature of the expenses being paid by the plan due to the netting of expenses against income or other hidden arrangements resulting in expenses not being apparent on the service provider statements. In these situations, the auditor may determine that additional inquiries with management and the service providers or review of service provider agreements may assist in understanding the fee arrangements. Consideration should be given to disclosing the terms of expense offset arrangements with third parties, whereby fees (for example, recordkeeping and so on) are reduced by a specified or readily ascertainable amount for services provided. Also, refer to the DOL-issued publication Understanding Retirement Plan Fees and Expenses and DOL Letter 2001-O1A to better understand and evaluate plan fees and expenses.

Payroll Data

.109 If one audit firm performs both the plan audit and corporate audit, there may be some efficiencies to be achieved surrounding the testing of payroll. Although testing of the payroll area may have been performed in conjunction with the corporate audit, relevant assertions related to payroll for the plan audit may or may not have been tested. When determining the scope of testing for the plan audit, the plan auditor may consider gaining an understanding of the assertions relevant to payroll that were tested during the corporate audit.

.110 For example, payroll testing performed for a corporate audit may not place any emphasis on individual amounts withheld and may be insufficient to satisfy the payroll testing requirements for a plan audit. Often payroll processing is outsourced to an outside service provider that may or may not have an appropriate SAS No. 70 report (see chapter 6 of Audit and Accounting Guide Employee Benefit Plans for further discussion of SAS No. 70 reports).

.111 If the plan sponsor has an internal audit department that has performed procedures on payroll data that is relevant to the audit, and it would be effective to incorporate their work into the audit, AU section 322, The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements (AICPA, Professional Standards, vol. 1), provides guidance on what the auditor needs to consider when making use of the internal auditors’ work in an audit.

Actuarial Reports for Defined Benefit Plans

.112 Several economic and demographic assumptions are used in actuarial valuations for defined benefit plans to determine funding requirements and the actuarial present value of accumulated plan benefits in accordance with FASB Statement No. 35. One of the most significant economic assumptions is the discount rate. Two approaches exist that can be used to select the discount rate. The most commonly used approach is to reflect the long term expected rate of return on assets. This amount is generally stable from one year to the next. This assumption would reflect anticipated growth of the actual underlying investments in the pension trust. Many employers are changing the mix of investments that have been used historically. For employers that are changing their mix of assets, the actual history of returns is not as relevant as new expectations for the new mix of assets. When an approach of looking at the long term expected return is used, the rate selected has generally been the same as that used for funding purposes. However, the PPA has changed the funding rate. The funding rate is no longer an appropriate rate for use in the plan’s financial statements under FASB Statement No. 35. Plans using “expected return on plan assets” as the basis for choosing the discount rate will now have to find a new benchmark. One of the most common approaches has
been to use the FASB Statement No. 87, *Employers’ Accounting for Pensions*, assumed return on plan assets. It is important to note that this is not the FASB Statement No. 87 discount rate. Therefore, auditors will need to take care when determining if the proper rate is disclosed in the benefit plan’s financial statements.

**.113** The second approach that may be used to select the FASB Statement No. 35 discount rate is to select a rate that reflects an insurance company’s purchase rates as of the benefit information date. Because this is a settlement type of rate, it may be similar to (but not necessarily the same as) the FASB Statement No. 87 discount rate. A discount rate selected on this basis can be expected to change from year to year to reflect changes in the long term interest rate markets. Throughout 2008 long term interest rates increased significantly. This was largely due to risk factors related to the subprime mortgage crisis. However, rates dropped sharply in December. At December 31, 2008, long term interest rates had decreased by 150 basis points from November. Because of the volatility in rates, those plans that base the discount rate on a settlement type rate and that use end-of-year benefit information may see either increases or decreases in the discount rate compared to a year earlier. Plans that use beginning of year information will experience increases in the discount rate that will provide for gains.

**.114** The most significant demographic assumptions used to determine the actuarial present value of accumulated plan benefits include mortality rates, retirement age, form of payment or type of benefit elections and cash balance crediting rates if applicable. With the increase in life expectancies, the mortality assumption should include improvements to longevity that were not included in earlier tables. Certain mortality tables used by actuaries include the 1983 GAM, 1994 GAM, UP 1994, and RP 2000 tables. Auditors may consider challenging the use of such tables for purposes of determining the FASB Statement No. 35 liability beginning in 2007. For 2007 calendar year plans and beyond, a new mortality table is required as part of the minimum required contribution calculation. This table, which is based on the RP 2000 mortality table, has replaced the 1983 GAM table. Many actuarial reports will refer to this table as the RP 2000 Combined Mortality Table with projections as specified by IRS Regulation 1.412(1)(7)-1. It has been common practice to use the same table for FASB Statement No. 35 purposes as is required for minimum funding purposes. It can therefore be expected that the RP 2000 table with or without the IRS required projections will be used frequently for 2008 valuations. It is possible that the use of the 1983 GAM table may continue to be acceptable depending on the plan’s experience; however, most plans will be changing to use the 1994 GAM, UP 1994, or the recent RP 2000 tables for their mortality assumptions. It is expected that plan sponsors will consider the demographics of their participant population prior to utilizing a mortality table in determining the actuarial present value of accumulated plan benefits.

**.115** The medical trend assumption is unique to postretirement health and welfare plans. This assumption is intended to project the current cost of health care benefits to future periods when those benefits will be paid. Health care costs have traditionally increased at a faster rate than general inflation. In addition to general inflation, health care costs are affected by increased utilization of plan benefits, rising cost of medical technology, and the leveraging effect of plan provisions such as copays and deductibles. Taken together, these factors contribute to cost increases well above the rate of general inflation. Most actuaries assume that these excess cost increases will continue in the near term but will ultimately merge with general inflation rates. Therefore, a common approach is to assume a higher trend rate for the current year and grade down to the general inflation rate after several years. An example is a trend rate of 9 percent for 2009 grading down by 0.50 percent each year until the ultimate rate of 5 percent is reached for 2017 and beyond. Auditors should question trend assumptions that only reflect general inflation for all years.

**.116** Regardless of the assumption used, each assumption must be individually reasonable. Plan management ordinarily should review actual plan experience with assumptions used periodically to determine if any changes should be made. The following may also be considered as plan auditors review actuarial valuations:

- Trends and nature of benefit distributions (for example, lump sum versus annuity)—a plan that predominantly pays lump sum benefits may have a higher obligation than an equivalent plan that pays annuities. To properly value the plan’s liabilities, there must be assumptions used to reflect the cost of the lump sum benefits. If only assumptions exist that reflect annuities, the lump sum benefits may be undervalued.
Whether there has been a shift in the plan population over time—this could warrant a different assumption for turnover or retirement, for example, if participants are retiring much earlier or later than assumed.

Whether there have been recent plan mergers or acquisitions—in the case of a plan merger, all assumptions would be reviewed for their continued reasonableness because the assumptions used for one plan may not be appropriate for the plan being merged.

Whether there have been any plan benefit formula changes or a freezing of the plan—changes in plan benefits available may affect anticipated turnover and retirement patterns. These assumptions would be reviewed if the plan is amended to change benefits.

Whether consistent gains and losses are generated each year—if yes, this may indicate that one or more of the assumptions are not reasonable based on actual experience.

When reviewing an actuarial report, consideration may be given to

- consistency of benefits accumulated each year (auditors would expect changes if there has been a plan merger, acquisition, a significant plan provision change, or changes to the underlying assumptions).
- benefit payments in the roll forward of accumulated plan benefits, which should match the amount per the statement of changes in net assets (to properly match these amounts, it is necessary to understand if the beginning of the year or end of the year information is used for the actuarial valuation).
- the asset value on the financial statements, which should match the asset value shown in the actuarial report.
- inclusion of the effect of a change in plan provisions and the effect of merger, spin-off, or acquisition.

It is also important to note that the assumption of salary increases may not be relevant for FASB Statement No. 35 because the statement is based on the disclosure of the actuarial present value of accumulated plan benefits that does not take into account future salary increases. It may have some relevance if the actuary does not have or maintain salary histories for the plan participants and the salary increase assumption is used to estimate prior salary histories.

The Use of Beginning of Year Benefit Information Date

The presentation of the financial statement information and the footnotes are affected by the benefit information date selected for disclosure. The preferred approach is to use an end-of-year benefit information date. If end-of-year is presented, the present value of accumulated plan benefits will be as of the same date as the net assets. In this case, at a minimum, there will be two statements of net assets available for benefits and one statement of changes in net assets. There will be two corresponding statements (or disclosure in the footnotes) of the present value of accumulated plan benefits and one statement of changes. Examples of this are shown in exhibits D-1, D-2, D-3, and D-4 of Audit and Accounting Guide Employee Benefit Plans.

However, if beginning-of-year benefit information is used, the date of the benefit information in the actuarial report may not match the date that net assets are presented. For example, for financial statements presented as of December 31, 2008, and December 31, 2007, the actuarial valuation will be as of January 1, 2008. For the benefit information to match the statement of net assets, the present value of accumulated plan benefits should be presented as of December 31, 2007 (one day earlier). Typically, this will not cause a material misstatement unless there was a plan amendment that was adopted on or after January 1, 2008, with a January 1, 2008, effective date. In that case, the effect of the amendment must be removed. As shown in Audit and Accounting Guide Employee Benefit Plans, when beginning-of-year benefit information is used, two statements of net assets and two statements of changes would be presented. Only a single year of present value of accumulated plan benefits is required with a reconciliation from the prior year. Examples of this are shown in exhibits D-1, D-7, and D-8 of Audit and Accounting Guide Employee Benefit Plans.
Allocation Testing for Defined Contribution Plans

.120 One of the objectives of auditing procedures applied to individual participant accounts of a defined contribution plan is to provide the auditor with a reasonable basis for concluding whether net assets and transactions have been properly allocated (sometimes referred to as credited or charged, as applicable) to participant accounts in accordance with the plan documents. In some cases, the plan documents specify how certain plan activity is to be allocated. After the auditor obtains an understanding of what and how allocations are made, participant account activity during the year (for example, contributions, income allocations, expense allocations, and forfeiture allocations) would be taken into consideration in the determination of auditing procedures including consideration of reliance on a SAS No. 70 type 2 report, if available.

Help Desk—Investment income (loss) has several components, not all of which are always allocated at individual participant accounts. For example, net appreciation or depreciation is typically not allocated to participant accounts but is derived by the recordkeeping system based on the end of day pricing of investments. Dividend and interest income is often times immaterial to the financial statements taken as a whole, yet it is typically allocated.

.121 One method to test certain allocations is to recalculate activity for individual participants (for example, deferral or matching contributions). Other allocations may be performed electronically by the recordkeeping system, and it may be more efficient to rely on the SAS No. 70 type 2 report to reduce the scope of the substantive testing. Some of the additional substantive procedures the auditor may consider in addition to obtaining the SAS No. 70 type 2 report for participant allocations include

- reconciling the summation of participant accounts by investment option to investment balances.
- testing adjustments to participant accounts during the period.
- testing the participant complaint process including the resolution of complaints.

.122 Based on the results of those procedures as well as the auditor’s overall risk assessment of participant accounts, the auditor can determine if additional procedures are required, such as

- performing scanning analytics of participant activity (for example, contributions, benefit payments, and income allocation) during the period or
- confirming allocation activity directly with participants.

Help Desk—In a limited scope audit, the allocation of investment income to individual accounts is not certified by the trustee or custodian and therefore would be considered for testing by the auditor.


Missing Participant Data

.124 Plan sponsors and service providers have significant data storage burdens given the volume of paper and electronic records associated with ERISA plans and a number of plan sponsors have experienced difficulty in maintaining all pertinent participant data relating to census data and benefit payments. Often, plan sponsors do not maintain the proper detail supporting the deferred vested benefits for defined benefit plans (for example, eligibility records, individual census data, compensation records, employee work history, and so on). Lapses in maintaining data can be caused for various reasons, such as
• the result of a corporate transaction (for example, plan merger, spinoff, change in sponsorship, and so on).
• a change in service providers (for example, actuaries or other third-party administrators).
• a natural disaster (for example, a fire, flood, and so on).
• the inadvertent destruction or disposal of records.

.125 Irrespective of the various document retention requirements under federal and individual state laws, two basic record retention provisions under ERISA exist:

• Section 107 of ERISA requires anyone who must file a report (such as Form 5500) or certify information under Title 1 of ERISA to maintain sufficient records to verify, explain, or clarify the information contained in such reports for not less than 6 years after the filing of the report.
• Section 209 of ERISA requires every employer to maintain records necessary to determine benefits due or that may become due to each of its employees.

.126 As a result, employers should assume that records regarding plan benefits must be maintained indefinitely (either in their original paper form or electronically under certain conditions), or at least long enough such that they will never be needed to determine the eligibility for, or the amount of, a benefit. Failure to retain necessary documents, even if not specifically required to be kept by law, can result in very unfortunate consequences including significant costs and fees (for example, recreation of records, litigation defense, and so on).

.127 When auditors are unable to obtain the necessary information to test participant data or benefit payments, this could be considered a restriction on the scope of the audit. According to AU section 508, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1), restrictions on the scope of the audit, whether imposed by the client or by circumstances (such as the timing of his or her work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records), may require the auditor to qualify his or her opinion or to disclaim an opinion. In these situations, the auditor will need to determine how significant the restriction on the scope of the audit is to the overall engagement to determine the effect on the auditor’s report.

.128 The missing participant data issue is exacerbated when a change in auditor occurs, especially for defined benefit plans. Often, the predecessor auditor has been auditing the participant data for years and is comfortable with the cumulative audit knowledge. However, if the participant data have not been maintained, the successor auditor may have a scope limitation. Prior to accepting a new benefit plan engagement, auditors may wish to take special care in determining if any missing participant data exists.

.129 Auditors may recommend that the plan sponsor consult with legal counsel and consider contacting the DOL prior to attaching a qualified or disclaimer of opinion relating to a Form 5500 filing for a benefit plan.

Securities Lending

.130 Many employee benefit plans take part in securities lending programs. Often it is not evident from the trustee or custodial investment reports that the securities lending arrangements exist. Identification of such arrangements can be achieved through discussions with (a) those responsible at the plan sponsor for investment decisions or (b) investment service providers (for example, investment advisors, trustees/custodians, and so on) or review of all investment related agreements.

.131 Under FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125, plans that engage in securities lending should present the assets received in return for the securities, as well as the exchanged securities, on the statement of net assets available for benefits. The exchanged securities, as well as the assets received for them (if an investment) should be reported on the ERISA required supplemental schedule of assets (held at end of year)
with the appropriate disclosures. Also refer to paragraphs 2.32–35, 3.39–43, and 4.57–61 of Audit and Accounting Guide Employee Benefit Plans for further information.

.132 Employee benefit plans that participate in securities lending programs through security lending agents typically receive cash collateral for security loans. The cash is often invested in security lending cash collateral funds that are managed by the agent or parties affiliated with the agent. Although some collateral funds are money market funds registered with the SEC and subject to Rule 2a-7 under the Investment Company Act of 1940, many—even some holding themselves out as managed in a way similar to Rule 2a-7—are not registered. Unregistered collateral funds often invest in securities with longer maturity and higher risk than typical short-term “money market” type securities. Accordingly, it is important for benefit plans to verify the exact nature of the collateral funds used for investment of cash collateral. As a result of financial market conditions, many unregistered collateral funds have a net asset value per unit/participation interest (NAV) based on current fair values of underlying assets significantly less than $1, yet the collateral funds continue to issue and redeem their units/participation interests (units) at $1, as may be allowed by the relevant legal agreements. A number of those collateral funds have placed restrictions on redemption. Examples of audit procedures the auditor may perform regarding management’s determination of the fair value of the collateral fund at year-end, may include obtaining a copy of the collateral fund audited financial statements, if available, and comparing the value to what was reported in the benefit plan financial statements.

Form 11-K Audits

.133 The SEC requires employee stock purchase, savings, and similar plans with interests that constitute securities registered under the Securities Act of 1933 to file Form 11-K pursuant to Section 15(d) of the Securities Exchange Act of 1934. Plans that are required to file a Form 11-K are deemed to be issuers under the Sarbanes-Oxley Act and must submit to the SEC an audit in accordance with the auditing and related professional practice standards promulgated by the PCAOB.

Practice Tip: Instructions for completing Form 11-K can be accessed under topic 15 of the SEC manual located on www.sec.gov.

.134 The PCAOB establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review Audit Risk Alert SEC and PCAOB Developments—2008 (product no. 022499kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by visiting www.cpa2biz.com.

**Recent PCAOB Pronouncements and Related Guidance**

<table>
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<tr>
<th>Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 6, Evaluating Consistency of Financial Statements (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)</th>
<th>This standard and its related amendments update the auditor’s responsibilities to evaluate and report on the consistency of a company’s financial statements and align the auditor’s responsibilities with FASB Statement No. 154, Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3, which is codified at FASB Accounting Standards Codification (ASC) 250, Accounting Changes and Error Corrections. This standard also improves the auditor reporting requirements by clarifying that the auditor’s report should indicate whether an adjustment to previously issued financial statements results from a change in accounting principles or the correction of a misstatement. It is effective November 15, 2008.</th>
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<tr>
<td>Issue Date: September 2008 (Applicable to audits conducted in accordance with PCAOB standards)</td>
<td></td>
</tr>
</tbody>
</table>
### Recent PCAOB Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
</table>
| **PCAOB Rule 3526, Communication with Audit Committees Concerning Independence** (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”) | Rule 3526 requires the registered public accounting firm to:
- describe in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence.
- discuss with the audit committee of the issuer the potential effects of any relationships that could affect independence, should they be appointed as the issuer’s auditor.
- document the substance of these discussions. These discussions should occur at least annually.
The board also adjusted the implementation schedule for Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles* (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”), as it applies to tax services. |
| **SEC Release 2008-234, Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting** | This press release was provided jointly by the Securities and Exchange Commission (SEC) and FASB staffs and was intended to help preparers, auditors, and investors address fair value measurement questions based on the fair value measurement guidance in FASB Statement No. 157, *Fair Value Measurements*, that have been cited as most urgent in the current environment. More information is available online at [www.sec.gov/news/press/2008/2008-234.htm](http://www.sec.gov/news/press/2008/2008-234.htm). |
| **PCAOB Staff Audit Practice Alert No. 3, Audit Considerations in the Current Economic Environment** (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 400.03) | This practice alert is designed to assist auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis. The practice alert addresses the following six main areas: overall audit considerations, auditing fair value measurements, auditing accounting estimates, auditing the adequacy of disclosures, auditor’s consideration of a company’s ability to continue as a going concern, and additional audit considerations for selected financial reporting areas. |

### Form 8-K Requirements for Form 11-K Filers

.135 For an employee benefit plan required to file Form 11-K, the SEC staff has historically expected a change in a plan’s auditor to be reported on Form 8-K; however, plans that filed their financial statements as part of the plan sponsor’s annual report (as provided for in Securities Exchange Act of 1934 Rule 15d-21) have not been expected to report changes in its auditors on Form 8-K. This requirement was discussed at the April 4, 2006, AICPA SEC Regulations Committee meeting, and although the SEC staff unofficially stated that all employee stock purchase, savings, or similar plans that change auditors are not required to file a Form 8-K.
(regardless of whether it files its annual financial statements on Form 11-K or as part of the plan sponsor’s annual report), the committee observed that, under Section 1000.08(m), Notification of the Commission of Resignations and Dismissals from Audit Engagements for Commission Registrants, of the PCAOB Interim Quality Control Standards, an independent registered public accounting firm is required to report the termination of the auditor-client relationship for any SEC registrant, which is defined to include employee benefit plans that file Form 11-K. This communication should be in writing directly to the former client, with a simultaneous copy to the Office of the Chief Accountant (OCA) of the SEC. This letter should be sent by the end of the fifth business day following the firm’s determination that the client-auditor relationship has ended (or it may be faxed to the OCA at (202) 772-9251 with a reference to “PCAOB Letter File”). The SEC staff agreed to discuss its position on Form 8-K reporting by employee benefit plans with the PCAOB staff. Until authoritative guidance is provided by the SEC that provides a specific exemption, public accounting firms should continue to provide these “5-day” letters to comply with PCAOB requirements for a change in auditor of a plan that files a Form 11-K. An employee benefit plan whose financial statements are filed as an amendment to the sponsor’s Form 10-K does not meet the definition of an SEC engagement and would therefore fall outside the scope of Section 1000.08(m).

Preapproval of Employee Benefit Plan Audits

.136 In December 2005, the SEC issued “Current Accounting and Disclosures Issues in the Division of Corporation Finance” to provide guidance regarding the preapproval of audits of employee benefit plans. Section II.R.3 is summarized in the following paragraph. An employee benefit plan may be an affiliate of a registrant as its plan sponsor. The SEC’s independence rules related to preapproval surround services provided to the issuer and the issuer’s subsidiaries but not to services provided to other affiliates of the issuer that are not subsidiaries. Therefore, the independence rules do not require the audit committee of the plan sponsor to preapprove audits of the employee benefit plans, although the audit committee is encouraged to do so. When employee benefit plans are required to file Form 11-K, those plans are separate issuers under the Exchange Act; as a result, those issuers are subject to the preapproval requirements.

.137 This preapproval can be provided by either the audit committee of the plan sponsor or the appropriate entity overseeing the activities of the employee benefit plan, such as the trustee, plan administrator, or responsible party. The SEC’s rules require that all fees, including fees related to audits of employee benefit plans, paid to the principal auditor be included in the company’s fee disclosures, regardless of whether the audit committee of the company preapproved those fees. As part of the exercise to gather the information for the required fee disclosures, the audit committee should be made aware of all fees paid to the principal auditor, including those related to audits of the employee benefit plans. The company may elect to separately indicate in their disclosures those fees paid to the principal auditor that were not subject to the preapproval requirements. Registrants and their auditors are reminded that the financial statements included in Form 11-K must be audited by an independent auditor who is registered with the PCAOB, and the audit report must refer to the standards of the PCAOB rather than GAAS.

Audit Reports—Following Two Sets of Standards

SEC Requirements

.138 The SEC requires employee stock purchase, savings, and similar plans with interests that constitute securities registered under the Securities Act of 1933 to file Form 11-K pursuant to Section 15(d) of the Securities Exchange Act of 1934. When Form 11-K is filed separately (not as an exhibit to Form 10-K), it must be filed with the SEC within 90 days after the end of the plan’s fiscal year-end; however, if the plan is subject to ERISA, the Form 11-K filing deadline is increased to 180 days after the plan’s fiscal year-end.

Applicable Audit Standards

.139 Plans that are required to file Form 11-K are deemed to be issuers under the Sarbanes-Oxley Act and must submit to the SEC an audit in accordance with the auditing and related professional practice standards promulgated by the PCAOB. These plans may also be subject to ERISA and must submit to the DOL an audit
in accordance with GAAS promulgated by the ASB. It is our understanding that the SEC will not accept an audit report that references GAAS, and the DOL will not accept an audit report that does not reference GAAS.

**Performance and Reporting Requirements**

.140 Based on AICPA staff discussions with the SEC and PCAOB staff to seek clarification of the performance and reporting requirements for audits of Form 11-K filers, firms will need to conduct their audits of these Form 11-K plans in accordance with two sets of standards and prepare two separate audit reports: an audit report referencing PCAOB standards for Form 11-K filings with the SEC and a separate audit report referencing GAAS for DOL filings. The PCAOB and SEC staff believe that an opinion issued in accordance with PCAOB Auditing Standard No. 1, *References in Auditors’ Reports to the Standards of the Public Company Accounting Oversight Board (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)* (www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.1.aspx), does not allow a reference to GAAS; therefore, a “dual” standard report is not appropriate and will not be accepted by the SEC.

.141 Any questions regarding performance and reporting requirements of audits of financial statements of Form 11-K filers should be directed to the SEC Division of Corporation Finance, OCA at (202) 551-5300. See paragraph 13.19 of Audit and Accounting Guide *Employee Benefit Plans* for an example of an opinion for a Form 11-K audit.

**Auditing Accounting Estimates**

.142 As noted in paragraph .04 of AU section 342, the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as whole. Although this alert has discussed fair value measurements at length, it is important to remember that many types of accounting estimates exist in client financial statements. Some examples include the allowance for uncollectible accounts receivable, impairment analysis and estimated useful lives of long-lived assets, valuation allowance for deferred tax assets, and actuarial assumptions in pension and other postretirement benefit costs. Given the current economic climate, additional skepticism should be exercised when considering management’s underlying assumptions used in accounting estimates. When evaluating accounting estimates, the auditor should consider both the subjective and objective factors, with professional skepticism. As discussed in paragraph .09 of AU section 342, key factors and assumptions that the auditor normally concentrates on include the assumptions that are significant to the estimate, sensitive to variations, deviate from historical patterns, or are particularly subjective and susceptible to misstatement and bias; however, it is important to consider whether historical patterns are still applicable. For example, in the current slow market, new patterns may emerge. A key aspect of AU section 342 in this economy is for an auditor to determine the reasonableness of management’s accounting estimates with an extra degree of professional skepticism, given the current economic climate and possible increases of pressure on management to meet earnings. As noted by AU section 316, when assessing audit differences between client estimates and audit estimates, even if they are individually reasonable, an auditor should consider whether these differences are indicative of possible bias by management. If so, the auditor should reconsider the estimates taken as a whole.

.143 The auditor should obtain an understanding of how management develops estimates and should employ one of the approaches outlined in AU section 342 paragraph .10 in testing that process. In reviewing and testing management’s process, the auditor may consider identifying controls around this process and determining if the underlying data used for the estimate are reliable and used appropriately. An auditor also may develop an estimate and compare it to management’s estimate. Lastly, the auditor may review subsequent events or transactions occurring prior to the date of the auditor’s report. Further, as noted in AU section 316, hindsight may provide the auditor additional insight into the existence of management bias. For further details on auditing estimates, see AU section 342.
Management Letter of Representations

.144 As discussed in AU section 333, Management Representations (AICPA, Professional Standards, vol. 1), in some circumstances, audit evidence that can be obtained by the application of auditing procedures other than inquiry is limited; therefore, the auditor obtains written representations to provide additional audit evidence. This may be the case for assumptions used in fair value measurements or the entire measurement or claims around an entity’s ability to continue as a going concern.

.145 According to paragraph .48 of AU section 328, “[t]he auditor should ordinarily obtain written representations from management regarding the reasonableness of significant underlying assumptions, including whether they appropriately reflect management’s intent and ability to carry out specific courses of action on behalf of the entity where relevant to the use of fair value measurements or disclosures.” Additionally, depending on the nature, materiality, and complexity of fair values, representations may be included in regard to the appropriateness of the measurement methods and consistency in the application of these methods, the completeness and adequacy of disclosures related to fair values, and whether subsequent events require adjustment to the fair value measurements and disclosures included in the financial statements. When significant assumptions are used or they are highly subjective, and the items being measured at fair value are material, the auditor considers discussing these items with those charged with governance of the entity.

Accounting Issues and Developments

Unrelated Business Income Tax and FASB Interpretation No. 48

.146 Although qualified benefit plans are not generally subject to taxation, certain activities of a qualified plan may be taxable. In general, unrelated business taxable income (UBTI) of a tax-exempt entity is subject to taxation. UBTI is:

- gross income derived from an unrelated trade or business that is regularly carried on, less
- allowable deductions directly connected with the trade or business.

.147 With respect to qualified retirement plans, unrelated trade or business is defined as any trade or business regularly carried on by the trust or by a partnership of which the trust is a member. This means that a qualified plan can have UBTI due to its investments. For tax-exempt welfare plans, UBTI includes the previous examples. In addition, such plans may be subject to UBTI on their investment income if their assets exceed certain allowable reserves.

.148 Nonleveraged investments, such as government securities, stocks, and debt instruments of noncontrolled corporations, mutual funds, and insurance company annuity contracts, do not typically generate UBTI. However, other nonleveraged investments, such as investments in partnerships, real estate investment trusts, loans or mortgages, and options to buy or sell securities such as short sales or repurchase agreements, may generate UBTI. The most common plans that generate UBTI are health and welfare plans and defined benefit pension plans. However, with the increase of such investments held by DC plans, such plans may begin to be subject to UBTI also.

FASB Interpretation No. 48

.149 FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109, clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. See FIN 48 for further guidance.
For public enterprises (including nonpublic consolidated entities of public enterprises that apply GAAP), this interpretation is effective for fiscal years beginning after December 15, 2006. For nonpublic enterprises (as defined in paragraph 289 of FASB Statement No. 109), except for nonpublic consolidated entities of public enterprises that apply U.S. GAAP, this interpretation is effective for annual financial statements for fiscal years beginning after December 15, 2008. See FSP FIN 48-3, Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises, for further guidance on the effective date. Earlier adoption is permitted as of the beginning of an enterprise’s fiscal year.

Considerations for Employee Benefit Plans

FSP FIN 48-3 has generally deferred the effective date of the application of FIN 48 for nonpublic companies to fiscal years commencing after December 15, 2008. However, when applied, the standard will require assessment of uncertainty of income tax positions for all open years. As such, the auditor may wish to consider the implications of this standard during 2008 benefit plan audits.

Because benefit plans are generally exempt from income taxes, few issues exist that may trigger the application of FIN 48. The main concern for all plans is the retention of the plan’s tax-exempt status. For retirement plans, the existence of the IRS’s Employee Plans Compliance Resolution System under Revenue Procedure 2008-50 is generally assumed to meet the conditions of an administrative practice or precedent as defined in FIN 48, which can be relied upon to retain the plan’s exempt status for all but the most egregious of violations. Note that no such relief program exists for welfare benefit plans.

Notwithstanding this general relief for the plan’s tax qualified status, a plan may be faced with issues under FIN 48. These potential issues include, but are not limited to, the following:

- Uncertain tax positions taken by pass-through entities in which the plan has invested that generate material unrelated business income tax to the trust
- The determination of whether a pass-through entity generates unrelated business income to the plan
- The assumptions used in determining the reserves for a welfare benefit plan that is subject to unrelated business income tax due to excess asset accumulations
- The assumptions used by an ESOP of an S corporation to demonstrate satisfaction with the “broadly held” rules of IRC Section 409(p) and the associated exemption from tax on the pass-through income
- The continuation of a welfare benefit plan’s tax exempt status
- Where UBTI is material, all aspects of FASB Statement No. 109, including an analysis of any book or tax differences, is required

FASB Accounting Standards Codification™

FASB is expected to issue FASB ASC as authoritative effective July 1, 2009, at which time it will become the source of authoritative U.S. accounting and reporting standards, in addition to guidance issued by the SEC, for nongovernmental entities. FASB ASC will supersede all then-existing, non-SEC accounting and reporting standards for nongovernmental entities. Once effective, all other nongrandfathered, non-SEC accounting literature not included in FASB ASC will become nonauthoritative. This change will affect accountants and auditors alike.

FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing all authoritative literature in a topically organized structure. FASB ASC disassembled and reassembled thousands of nongovernmental accounting pronouncements (including those of FASB, the Emerging Issues Task Force (EITF), and the AICPA) to organize them under approximately 90 topics. FASB ASC includes all accounting standards issued by a standard setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, EITF, AICPA, and related literature. FASB ASC also includes relevant portions of authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance issued by the SEC; however, FASB ASC is not the official source.
of SEC guidance and does not contain the entire population of SEC rules, regulations, interpretive releases, and staff guidance.

.156 After the effective date of FASB ASC, FASB will no longer consider new standards authoritative in their own right. Instead, new standards will serve only to update FASB ASC and provide the historical basis for conclusions of a new standard.

.157 FASB ASC uses a topical structure in which guidance is organized into areas, topics, subtopics, sections, and subsections. Topics, subtopics, and sections are numerically referenced. The topics of FASB ASC pertaining to employee benefit plans are the following:

- 960, Plan Accounting—Defined Benefit Pension Plans
- 962, Plan Accounting—Defined Contribution Pension Plans
- 965, Plan Accounting—Health and Welfare Benefit Plans

.158 Constituents are encouraged to begin using FASB ASC, which can be accessed at http://asc.fasb.org/home.

.159 The AICPA has published Financial Reporting Alert FASB Codification Developments—2008 (product no. 029209kk). This Financial Reporting Alert is intended to provide a better understanding of FASB ASC, outline its structure, as well as provide case studies on navigating FASB ASC Research System and performing accounting research.
Recent Pronouncements

The following tables present a list of recently issued audit and attestation pronouncements and related guidance as well as a list of accounting pronouncements and related guidance. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. The PCAOB establishes auditing and attestation standards for audits of issuers. For information on pronouncements issued subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org, the FASB Web site at www.fasb.org, and the PCAOB Web site at www.pcaob.org. You may also look for announcements of newly issued accounting standards in the CPA Letter and the Journal of Accountancy.

### Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Statement on Auditing Standards (SAS) No. 116, <em>Interim Financial Information</em> (AICPA, <em>Professional Standards</em>, vol. 1, AU sec. 722)</th>
<th>This standard amends AU section 722 to accommodate reviews of interim financial information of nonissuers, including companies offering securities pursuant to SEC Rule 144A or participating in private equity exchanges. It is effective for reviews of interim financial information for interim periods beginning after December 15, 2009. Earlier application is permitted.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue Date: February 2009</td>
<td></td>
</tr>
<tr>
<td>(Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])</td>
<td></td>
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<tr>
<td>SAS No. 115, <em>Communicating Internal Control Related Matters Identified in an Audit</em> (AICPA, <em>Professional Standards</em>, vol. 1, AU sec. 325)</td>
<td>Replacing SAS No. 112, <em>Communicating Internal Control Related Matters Identified in an Audit</em> (AICPA, <em>Professional Standards</em>, vol. 1, AU sec. 325A), this standard defines the terms <em>deficiency in internal control</em>, <em>significant deficiency</em>, and <em>material weakness</em>; provides guidance on evaluating the severity of deficiencies in internal control identified in an audit of financial statements; and requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit. It is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.</td>
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<tr>
<td>Issue Date: October 2008</td>
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<td>(Applicable to audits conducted in accordance with GAAS)</td>
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<td>Technical Questions and Answers (TIS) section 1900.01, “Condensed Interim Financial Reporting by Nonissuers” (AICPA, <em>Technical Practice Aids</em>)</td>
<td>This question and answer indicates that when preparing condensed interim financial statements, nonissuers may analogize to the guidance in Article 10 of SEC Regulation S-X regarding form and content because Accounting Principles Board (APB) Opinion No. 28, <em>Interim Financial Reporting</em>, does not provide a reporting framework. APB Opinion No. 28 is codified primarily at FASB Accounting Standards Codification (ASC) 270, <em>Interim Reporting</em>.</td>
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<tr>
<td>Issue Date: January 2009</td>
<td></td>
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<tr>
<td>(Nonauthoritative)</td>
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<tr>
<td>TIS section 9150.25, “Determining Whether Financial Statements Have Been Prepared by the Accountant” (AICPA, <em>Technical Practice Aids</em>)</td>
<td>This question and answer discusses what an accountant should consider in determining whether he or she has prepared the financial statements of a nonissuer.</td>
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<td>Issue Date: December 2008</td>
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Communicating Internal Control Related Matters Identified in an Audit

The ASB issued SAS No. 115, Communicating Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, vol. 1, AU sec. 325), which will become effective for audits of financial statements for periods ending on or after December 15, 2009. SAS No. 115 establishes standards and provides guidance on communicating matters related to a plan’s internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 115 supersedes SAS No. 112 of the same title. SAS No. 115 was issued to eliminate differences within the AICPA’s Audit and Attest Standards resulting from the issuance of SSAE No. 15, An Examination of an Entity’s Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements (AICPA, Professional Standards, vol. 1, AT sec. 501). SAS No. 115 aligns the definitions and related guidance for evaluating deficiencies in internal control with the definitions and guidance in SSAE No. 15. Specifically, SAS No. 115 does the following:

- Contains revised definitions of the terms material weakness and significant deficiency
- Revises the list of deficiencies in internal control that are indicators of material weaknesses
- No longer includes a list of deficiencies that ordinarily would be considered at least significant deficiencies
- Contains a revised illustrative written communication to management and those charged with governance of material weaknesses and significant deficiencies
Recent Accounting Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Recent Accounting Pronouncements and Related Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>FASB Statement No. 163(^1) (May 2008)</td>
</tr>
<tr>
<td>FASB Statement No. 162(^2) (May 2008)</td>
</tr>
<tr>
<td>FASB Statement No. 161 (March 2008)</td>
</tr>
<tr>
<td>(Codified at FASB Accounting Standards Codification [ASC] 815, Derivatives and Hedging)</td>
</tr>
<tr>
<td>FASB Emerging Issues Task Force (EITF) Issues (Various dates)</td>
</tr>
<tr>
<td>FASB Staff Positions (FSPs) (Various dates)</td>
</tr>
<tr>
<td>TIS section 6931.08–.10 (AICPA, Technical Practice Aids) (Nonauthoritative)</td>
</tr>
<tr>
<td>AICPA Practice Guide (Nonauthoritative)</td>
</tr>
</tbody>
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Disclosures About Derivative Instruments and Hedging Activities

.162 In March 2008, FASB issued FASB Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133. The new standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity’s financial position, financial performance, and cash flows.

.163 The new standard improves transparency about the location and amounts of derivative instruments in an entity’s financial statements; how derivative instruments and related hedged items are accounted for under FASB Statement No.133, Accounting for Derivative Instruments and Hedging Activities; and how derivative instruments and related hedged items affect financial position, financial performance, and cash flows.

.164 FASB Statement No. 161 achieves these improvements by requiring disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also provides more information about an entity’s liquidity by requiring disclosure of derivative features that are credit risk related. Finally, it requires cross-referencing within footnotes to enable financial statement users to locate important information about derivative instruments.

.165 It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged.

\(^1\) At the date of this writing, this guidance has not yet been included in Financial Accounting Standards Board Accounting Standards Codification TM (FASB ASC). Readers are encouraged to visit the FASB ASC Web site at http://asc.fasb.org/home and monitor updates.

\(^2\) See footnote 1.
Other Accounting Pronouncements

.166 In September 2008, FASB issued FSP FAS 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161*. This pronouncement addresses certain matters related to credit default swaps that may be held by large master trusts. Refer to the full text of FSP FAS 133-1 and FIN 45-4 at www.fasb.org/project/recent_effective_dates.shtml for further information.

Regulatory Developments

The DOL Provides Guidance on Fiduciary Duties in Response to Abuses Involving the Madoff Investment Firm

.167 On February 5, 2009, the DOL announced guidance on the duties of employee benefit plan fiduciaries in light of abuses involving Bernard L. Madoff Investment Securities LLC.

.168 This guidance is intended to assist fiduciaries, investment managers, and other investment service providers to plans who believe they may have exposure to losses on investments with entities related to the Madoff firm. The guidance also provides steps that can be taken to assess and protect the interests of plans, participants, and beneficiaries under ERISA.

.169 The guidance is available on EBSA’s Web site at www.dol.gov/ebsa under “Compliance Assistance.”

IRS Enhances Employee Plans Compliance Resolution System

.170 For many years, the IRS has sponsored a program granting plan sponsors a means of retaining a qualified retirement plan’s exempt status in spite of document or operating defects. This is the Employee Plans Compliance Resolution System (EPCRS). This program was updated in the spring of 2008, and announced in Revenue Procedures 2008-50. A complete discussion of the program, as well as some helpful tips, can be found at www.irs.gov/retirement/article/0,,id=96907,00.html.

.171 The 2008 revision to the compliance program continues the pattern of expanding the amount of relief available to plan sponsors. Areas under which correction relief has been enhanced include the following:

- Participant loans
- Failure to implement participant deferral elections
- Failure to recognize right to a catch-up correction
- Correction of an excess employer or employee contributions
- Use of the DOL’s online calculator for measuring lost income, if actual calculation is not feasible
- Disregard for corrections for former participants if $75 or less and costs of processing payment exceed that amount (prior rule was $50 or less)

.172 In addition to these enhancements, there has also been a procedural enhancement for requests for formal relief. Certain types of errors are eligible for a streamlined submission process, which should speed up the time from submission to formal approval.

.173 Familiarity with this program is important for benefit plan auditors as operational defects are frequently discovered during the course of the audit and an assessment must be made of whether corrections, if any, may be material. The full text of the revenue procedure includes a discussion of many common defects and the required correct, along with examples which are helpful in this assessment.
2008 Form 5500 Series

.174 On November 25, 2008, the DOL, IRS, and PBGC published the 2008 Form 5500 and related instructions.

.175 Modifications to Form 5500 for plan year 2008 are described under “Changes to Note” in the 2008 instructions. Significant changes include those covered in the following sections.

Modifications to the Form 5500 Annual Report for 2008

.176 Under the PPA, separate actuarial information schedules were developed for 2008 plan year filings. Single-employer and multiple-employer plans now will use Schedule SB and multiemployer and certain money purchase plans will now use Schedule MB. Schedule B is not a valid schedule to file with a plan’s 2008 Form 5500. Filers required to file an actuarial report cannot use the 2007 forms, including the 2007 Schedule B (Form 5500), to satisfy their 2008 filing requirements.

.177 The PPA requires filers of certain pension plans to provide additional new information beginning with the 2008 plan year. For the 2008 plan year, this new information will be filed as attachments to Schedule R. All multiemployer defined benefit plans are required to file attachments providing the information specified in the Schedule R instructions. In addition, all defined benefit plans (single-employer, multiple-employer, and multiemployer) with 1,000 or more participants are required to provide financial asset breakout information as an attachment to Schedule R.

.178 Under the PPA, a new simplified reporting option that was first available for 2007 plan year filings is also available for eligible plans for 2008 plan year filings for plans with fewer than 25 participants as of the beginning of the plan year. The instructions for “Voluntary Alternative Reporting Option for Certain Plans with Fewer than 25 Participants” on page 9 of the 2008 Instructions for Form 5500 describe this reporting option.

.179 Short 2009 plan year filers whose due date to submit their 2009 filing is before January 1, 2010, will be given an automatic extension to electronically file their complete Form 5500 within 90 days after the 2009 filing system is available on the DOL Web site. See the “When to File” section of the 2008 Instructions for Form 5500 for more information on due dates for short plan year filers.

Modifications to the Form 5500-EZ Annual Report for 2008

.180 Pursuant to the PPA, the filers of Form 5500-EZ are no longer required to file any schedules or attachments with Form 5500-EZ. They must, however, collect and retain a completed Schedule MB or a completed and signed Schedule SB, if applicable.

.181 To satisfy their 2009 Form 5500-EZ filing requirement, short plan year filers can choose to file electronically using what is expected to be an electronic 2009 Form 5500-SF, Short Form Annual Return/Report of Small Benefit Plan. More information is available at the IRS Web site at www.irs.gov.

.182 As with filers of the Form 5500, short 2009 plan year filers whose due date to submit their 2009 filing is before January 1, 2010, will also be given an automatic extension to electronically file their complete Form 5500 within 90 days after the 2009 filing system is available on the DOL Web site.

.183 The official government-printed forms are available by calling (800) TAX-FORM (800-829-3676). In addition, EBSA publications may be ordered by calling (866) 444-EBSA (3272). Information copies of the forms, schedules, and instructions are available on the EBSA’s Web site at www.efast.dol.gov.

.184 Filers should monitor the EFAST Web site for information on approved software vendors when completing 2008 Forms 5500 by computer and for electronic filing options. Filers may contact the EFAST Help Line for general assistance by calling (866) 463-3278.
Electronic Filing of Form 5500 and Changes to the 2009 Form 5500

.185 On November 16, 2007, the EBSA, the IRS, and the PBGC published in the Federal Register revisions to the Form 5500 for plan year 2009, including a deferral for one year of the move to the wholly electronic filing system. Plans and service providers will be required to comply with these changes on the due date for the plan’s 2009 Form 5500.

.186 Other highlights of the changes include the following:

- A new simplified annual reporting form for small plans with secure, easy to value investments with regulated financial institutions. The DOL estimates that approximately 594,000 of the 629,000 small plans required to file an annual report will be eligible to use the new Form 5500-SF, or short form.
- Removal of the IRS-only schedules (Schedules E and SSA) from Form 5500 as a result of the move to the wholly electronic filing system.
- Revision of the Schedule C to clarify the reporting requirements and improve the information plan officials receive regarding amounts being received by plan service providers.
- Replacement of Schedule B with Schedule SB and Schedule MB to reflect the changes in reporting and funding requirements for single and multiemployer defined benefit pension plans under the PPA effective for the 2008 plan year.
- Modification of Schedule R to add questions required by the PPA to gather information on pension plan funding and compliance with minimum funding requirements effective for the 2008 plan year but filed as an attachment rather than as actual schedules. These modifications will be effective in standard format for the 2009 plan year.
- Modification of Schedule R to collect data needed by the PBGC to properly monitor the plans it insures, effective for the 2008 plan year but filed as an attachment rather than as an actual schedule. These modifications will be effective in standard format for the 2009 plan year.
- Miscellaneous changes to the schedules and instructions to improve and clarify reporting effective for the 2009 plan year.
- Improved financial disclosure by the approximately 16,000 tax sheltered 403(b) annuity plans subject to Title I of ERISA by making the reporting rules for those 403(b) plans on par with 401(k) plans. This will involve the completion of Form 5500 as a small or large pension plan, depending on the number of participants eligible to participate in the plan as of the beginning of the plan year. The DOL anticipates that most small 403(b) plans will be eligible to use the new Form 5500-SF, and thus will only have to meet that limited filing obligation.

For large 403(b) plans, however, the new reporting requirements will require not only the completion of the entire Form 5500, but also the engagement of an IQPA to conduct an independent audit of the plan. The DOL intends to fully enforce this new audit requirement in 2009. Accordingly, it is critical that plan auditors educate themselves and their clients about this change and its effects on plan records that will be subject to audit. It is not uncommon for 403(b) plans, under the current reporting model, to have participant records that are difficult to “roll up” into plan-level records. Careful consideration of such situations will be essential in 2008 to ensure that these 403(b) plans will be auditable in 2009.
The 2009 Form 5500 package and the related *Federal Register* notices will be available on the EBSA EFAST Web site at www.efast.dol.gov.

**Help Desk**—In February 2008, the DOL selected a contractor, Vangent, Inc., to develop and build the new EFAST2 processing system. The new, wholly electronic processing system is expected to be operational on January 2, 2010, to process 2009 Form 5500 filings. Plan administrators and service providers are cautioned that the new EFAST2 processing system will not accept paper filings. Any such paper filings are not able to be processed and will be returned to the filer. To help the plan filing community understand the new EFAST2 system, the DOL has scheduled a series of webcasts during 2009.

**Correspondence From EFAST or the DOL OCA**

.188 Plan administrators often receive correspondence from the DOL regarding Form 5500 filed for their pension and welfare benefit plans. These letters are generated by both the EFAST processing center in Lawrence, KS, and the DOL’s OCA in Washington, D.C. Auditors are often asked by their clients to assist in the resolution of issues contained in these government letters.

**Processing-Related Correspondence—Changes are Coming on July 1, 2009**

.189 Since 2000, Form 5500 filings have been filed with the DOL’s EFAST processing center in Lawrence, KS. EFAST uses sophisticated electronic technologies to review each filing before acceptance. The DOL, IRS, and the PBGC have created a variety of edit tests designed to check for things such as completeness, accuracy, timeliness, internal consistency, missing schedules or attachments, and failure to answer mandatory questions.

.190 Since EFAST’s inception, the DOL has sent out “edit test” letters (also known as, the “30 day letters” from Lawrence, KS) addressed to plan administrators when deficiencies or discrepancies have been identified during processing. Plan administrators have been provided this opportunity to voluntarily correct deficiencies in their Form 5500 filings before any enforcement actions are taken by the DOL. At the end of this correspondence period, the data contained in the Form 5500 filings will have been distributed to the respective federal agencies regardless of whether deficiencies identified during processing have been resolved.

.191 Beginning July 1, 2009, the current EFAST processing system will no longer generate written “edit test” correspondence to plan administrators on Form 5500 filings containing deficiencies or discrepancies identified during processing, with one exception—the lack of a valid signature(s) on the Form 5500.

**Correspondence From the OCA**

.192 The DOL’s OCA has the responsibility for enforcing ERISA reporting and disclosure requirements. This includes ensuring that Form 5500 filings are filed timely and correctly, and determining whether plan audits are performed in accordance with professional auditing and regulatory standards. The OCA routinely queries the ERISA database and targets for review Form 5500 filings that satisfy certain criteria, including those filings in which processing errors went uncorrected and those with improperly prepared auditor’s reports. The OCA staff review the Form 5500 filings and also request copies of working papers that support
audit engagements. If the OCA staff identifies problems, a formal enforcement process commences with the issuance of a notice of rejection (NOR) against the plan administrator.

.193 Upon receipt of an NOR, the plan administrator has 45 days to make any necessary corrections to the Form 5500 filing. This may involve the auditors having to correct their audit reports or even perform additional fieldwork in audit areas where work was previously not performed or deemed by the DOL to be insufficient. At the end of the 45-day period, if the Form 5500 filing remains deficient, the DOL issues a notice of intent to assess a penalty (NOI), potentially subjecting the plan administrator to civil penalties of up to $1,100 per day (imposed from the day after the original due date of the filing). As a policy matter, however, most deficiencies are penalized at $150 per day with penalties capped at $50,000.

.194 When plan administrators receive an NOI, they have 35 days to submit to the DOL a statement of reasonable cause, submitted under penalty of perjury, in which they set forth any reasons why the penalty should be abated in part or in full. (It is important to note that traditionally the DOL will not consider abatement of any penalties in cases where deficiencies still exist.) If the plan administrator fails to comply with the requirements of the NOI, the penalty becomes a final agency action, and the plan administrator forfeits all appeal rights.

.195 After the DOL reviews the statement of reasonable cause, the agency issues a notice of determination that contains the final penalty amount assessed against the plan administrator. The plan administrators may choose to pay the penalty amount or, within 35 days as provided for in the letter, file an answer with the administrative law judge, appealing the penalty.

Important Reminders

.196 Given that the EFAST processing center will end its issuance of letters to plan administrators (with the one exception previously noted) on July 1, 2009, plan administrators should make all efforts to file accurate and complete Form 5500. Failure to do so may result in future enforcement correspondence from the DOL, IRS, or PBGC.

.197 Any questions regarding the DOL penalty process should be directed to the OCA at (202) 693-8360.

The EBSA’s Inspection Programs to Assess Plan Audit Quality

.198 The DOL’s EBSA continues its enhanced programs aimed at assessing and improving the quality of employee benefit plan audits. According to the EBSA, 68 public accounting firms audit more than 100 plans that cover approximately 28,000 audits. The remaining 48,000 plan audits are performed by nearly 10,000 different CPA firms, 8,200 of whom perform five or fewer audits. The EBSA utilizes both top-down and bottom-up strategies in selecting and evaluating ERISA audits.

.199 First, the EBSA conducts periodic inspections of firms with substantial ERISA audit practices—those with greater than 200 benefit plan clients. The EBSA staff meets with firm management, review firm policies and procedures that relate to employee benefit plan audits, and conduct on-site reviews of a sample of ERISA audit engagements. This “top-down” and “bottom-up” approach provides the EBSA a more efficient means of evaluating the quality of audit work performed by these large firms and ensuring that findings and recommendations are communicated to those in a position to effect any necessary changes. To date, the EBSA has completed 14 such reviews.

.200 Next, for firms that audit between 100 and 200 employee benefit plans, the EBSA carries out what it refers to as a mini-inspection program. This program is similar to the inspection program for larger firms, except that the work is performed in the EBSA’s Washington, D.C. office. The top-level communications with firm management and personnel are conducted using a firm questionnaire (also used in the larger inspection program) and telephone interviews. A sample of benefit plan engagements is also sampled, and firms are asked to make the audit workpapers available for review in the EBSA’s office. To date, the EBSA has completed mini-inspections of 15 firms.
The “top-down” and “bottom-up” approach utilized in both the inspection and mini-inspection programs provides the EBSA an efficient means of evaluating the quality of audit work performed by these large firms and ensures that findings and recommendations are communicated to those in a position to effect any necessary changes.

Finally, for firms with employee benefit plan audit practices of 50 or less plans, the EBSA focuses its in-house work on reviewing copies of selected audit working papers. When circumstances warrant, the scope of the EBSA’s reviews is expanded to additional audit areas. To date, the EBSA has conducted over 1,600 of these desk reviews.

In instances in which deficient audit work is identified, the related Form 5500 filings are subject to rejection, and auditors potentially face referral to the AICPA’s Professional Ethics Division or State Board of Public Accountancy.

Finally, the EBSA has expanded its enforcement efforts dealing with fiduciary breaches to include determining whether plan auditors may be considered knowing participants. An auditor is considered a knowing participant if at least one of the three following elements is present:

- The plan auditor took affirmative action to further the violation.
- The plan auditor helped conceal the violation.
- The plan auditor failed to act when required to do so by applicable professional standards.

DOL Fiduciary Education Campaign

The Fiduciary Education Campaign, a compliance assistance initiative of the DOL, is designed to improve workers’ health and retirement security by educating employers and service providers about their fiduciary responsibilities under ERISA. Such information and guidance is a cornerstone of the DOL’s mission.

The program emphasizes the obligation of plan sponsors and other fiduciaries to

- understand the terms of their plans;
- select and monitor service providers carefully;
- make timely contributions to fund benefits;
- avoid prohibited transactions; and
- make timely disclosures to workers and their beneficiaries and reports to the government.

The Fiduciary Education Campaign includes nationwide educational seminars and webcasts to help plan sponsors understand rules and meet their responsibilities to workers and retirees, thereby improving their financial security. The DOL’s Web site contains archived versions of these programs. The campaign also includes educational materials on topics such as understanding fees and selecting an auditor.

ERISA Fiduciary Advisor

The DOL has also developed an e-law tool to increase awareness and understanding about basic fiduciary responsibilities when operating a retirement plan. The ERISA Fiduciary Advisor provides information and answers to a variety of questions about who is a fiduciary and his or her responsibilities under ERISA. The advisor includes links to more detailed information that may be useful to the user, such as links to regulatory text, publications, and organizations.

This tool may be found at www.dol.gov/ebsa/fiduciaryeducation.html.
Publications

.210 Included in the DOL’s Fiduciary Education Campaign are the following DOL-issued publications:

.211 **Meeting Your Fiduciary Responsibilities.** To meet their responsibilities as plan sponsors, employers need to understand some basic rules, specifically ERISA, which sets standards of conduct for those who manage an employee benefit plan and its assets (called fiduciaries). This publication provides an overview of the basic fiduciary responsibilities applicable to retirement plans under the law.

.212 **Understanding Retirement Plan Fees And Expenses.** This booklet helps retirement plan sponsors better understand and evaluate their plan’s fees and expenses. Although the focus is on fees and expenses involved with 401(k) plans, many of the principles discussed in the booklet are applicable to all types of retirement plans.

.213 **401(k) Plan Fee Disclosure Tool.** This form provides employers with a handy way to make cost-effective decisions and compare the investment fees and administrative costs of competing providers of plan services.

.214 **Selecting an Auditor for Your Employee Benefit Plan.** Federal law requires employee benefit plans with 100 or more participants to have an audit as part of their obligation to file the Form 5500. This booklet will assist plan administrators in selecting an auditor and reviewing the audit work and report.

.215 **Selecting and Monitoring Pension Consultants: Tips For Plan Fiduciaries.** ERISA requires that fiduciaries of employee benefit plans administer and manage their plans prudently and in the interest of the plan’s participants and beneficiaries. In carrying out these responsibilities, plan fiduciaries often rely heavily on pension consultants and other professionals for help. To encourage the disclosure and review of more and better information about potential conflicts of interest, the DOL and SEC have developed a set of questions to assist plan fiduciaries in evaluating the objectivity of the recommendations provided, or to be provided, by a pension consultant.

.216 **Tips for Selecting and Monitoring Service Providers for Your Employee Benefit Plan.** Business owners are responsible for ensuring that their 401(k) plans comply with federal law and rely on other professionals to assist them with their plan duties. Selecting a service provider is one of the most important responsibilities of a plan sponsor. The EBSA has prepared this set of tips to assist business owners in carrying out these responsibilities.

.217 **Reporting and Disclosure Guide for Employee Benefit Plans.** This guide is intended to be used as a quick reference tool for certain basic reporting and disclosure requirements under ERISA.

**Help Desk**—Further information regarding DOL publications and the dates and locations of upcoming educational programs may be found at www.dol.gov/ebsa/fiduciary education.html.

Delinquent Filer Voluntary Compliance Program

.218 The Delinquent Filer Voluntary Compliance Program (DFVCP) is designed to encourage voluntary compliance with the annual reporting requirements under ERISA. The program gives delinquent plan administrators a way to avoid potentially higher civil penalty assessments by satisfying the program’s requirements and voluntarily paying a reduced penalty amount. To increase incentives for delinquent plan administrators to voluntarily comply, the department has reduced penalties and simplified the rules governing participation in the program.

.219 Address to be used for the DFVCP:
DFVCP Penalty Calculator and Online Payment Option

.220 The DOL provides two Web based options that make participating in the DFVCP easy, quick, and error-free. An online DFVCP penalty calculator is available to help plan administrators accurately calculate the payment needed to participate in the program. In addition, plan administrators who use the online calculator now have the option of paying the penalty electronically over the Internet.

.221 Additional details on the online calculator and online payment option may be found in the DFVCP Frequently Asked Questions (FAQs) at www.dol.gov/ebsa/calculator/dfvcpmain.html.

Program Eligibility

.222 Eligibility in the DFVCP continues to be limited to plan administrators with filing obligations under Title I of ERISA who comply with the provisions of the program and who have not been notified in writing by the DOL of a failure to file a timely annual report under Title I of ERISA. Form 5500-EZ filers and Form 5500 filers for plans without employees (as described in 29 U.S. Code of Federal Regulations [CFR] 2510.3-3[b] and [c]) are not eligible to participate in the DFVCP because such plans are not subject to Title I.

Program Criteria

.223 Participation in the DFVCP is a two-part process. First, plan administrators file with the EBSA a complete Form 5500, including all schedules and attachments, for each year relief is requested. Special simplified rules apply to “top hat” plans and apprenticeship and training plans. Second, plan administrators submit to the DFVCP the required documentation and applicable penalty amount. The plan administrator is personally liable for the applicable penalty amount, and, therefore, amounts paid under the DFVCP shall not be paid from the assets of an employee benefit plan.

Penalty Structure

.224 Per day penalty. The basic penalty under the program is $10 per day for delinquent filings.

.225 Per filing cap. The maximum penalty for a single late annual report is $750 for a small plan (generally a plan with fewer than 100 participants at the beginning of the plan year) and $2,000 for a large plan.

.226 Per plan cap. This cap is designed to encourage reporting compliance by plan administrators who have failed to file an annual report for a plan for multiple years. The per plan cap limits the penalty to $1,500 for a small plan and $4,000 for a large plan, regardless of the number of late annual reports filed for the plan at the same time. No “per administrator” or “per sponsor” cap exists. If the same party is the administrator or sponsor of several plans that are required to file annual reports under Title I of ERISA, the maximum applicable penalty amounts would apply for each plan.

.227 Small plans sponsored by certain tax-exempt organizations. A special per plan cap of $750 applies to a small plan sponsored by an organization that is tax-exempt under IRC Section 501(c)(3). The $750 limitation applies regardless of the number of late annual reports filed for the plan at the same time. It is not available, however,
if as of the date the plan files under the DFVCP a delinquent annual report exists for a plan year during which the plan was a large plan.

.228 Top hat plans and apprenticeship and training plans. The penalty amount for top hat plans and apprenticeship and training plans is $750.

IRS and PBGC Participation

.229 Although the DFVCP does not cover late filing penalties under the IRC or Title IV of ERISA, the IRS and PBGC agreed to provide certain penalty relief for delinquent Form 5500s filed for Title I plans in which the conditions of the DFVCP have been satisfied.

.230 Questions about the DFVCP should be directed to the EBSA by calling (202) 693-8360. For additional information about the Form 5500 series, visit the EFAST Web site at www.efast.dol.gov, or call the EBSA Help Desk toll-free at (866) 463-3278.

Voluntary Fiduciary Correction Program

.231 The Voluntary Fiduciary Correction Program (VFCP) encourages voluntary compliance by self-correcting violations of the law. The program also helps plan officials understand the law and gives immediate relief from payment of excise taxes under a class exemption.

.232 In April 2006, the EBSA expanded and simplified the VFCP to help employers and their professional advisors voluntarily correct violations of the law for employee benefit plans. This update to the VFCP reflects public comments and includes

- expansion and simplification of eligible transactions;
- streamlined documentation and clarified eligibility requirements;
- a model application form;
- clarification of what constitutes under investigation, allowing more entities to qualify for the program; and
- relief from civil penalties for transactions involving health and welfare plans.

.233 Under the VFCP, employers may voluntarily correct specific ERISA violations. Applicants must fully correct any violations, restore to the plan any losses or profits with interest, and distribute any supplemental benefits owed to eligible participants and beneficiaries. A no-action letter is given to plan officials who properly correct violations.

.234 The DOL also provides applicants conditional relief from payment of excise taxes for certain VFCP transactions under a class exemption related to the VFCP. The amended class exemption was also published in the Federal Register in April 2006.

.235 For more information about the VFCP, contact a local EBSA regional office through its toll-free number (866) 444-EBSA (3272) or visit the DOL online at www.dol.gov/ebsa.

DOL Outreach and Customer Service Efforts

.236 The DOL’s EBSA continues to encourage auditors and plan filers to call its Division of Accounting Services at (202) 693-8360 with ERISA-related accounting and auditing questions. Questions concerning the filing requirements and preparation of Form 5500 should be directed to the EBSA’s EFAST Help Desk at its toll-free number, (866) 463-3278.

.237 In addition to handling technical telephone inquiries, the EBSA is involved in numerous outreach efforts designed to provide information to practitioners to help their clients comply with ERISA’s reporting
and disclosure requirements. The agency’s outreach efforts continue to focus on plan audit quality, the current Form 5500, the EFAST Processing System, and other agency-related developments. Questions regarding these outreach efforts should be directed to the OCA at (202) 693-8360. Practitioners and other members of the public may also wish to contact the EBSA at its Web site at www.dol.gov/ebsa. The Web site also provides information on EBSA’s organizational structure, current regulatory activities, and customer service and public outreach efforts.

**Timeliness of Remittance of Participant Contributions Remains an Enforcement Initiative for the EBSA**

.238 The EBSA continues to focus on the timeliness of remittance of participant contributions in contributory employee benefit plans. Participant contributions are plan assets on the earliest date that they can reasonably be segregated from the employer’s general assets, but in no event later than (a) for pension plans, the 15th business day of the month following the month in which the participant contributions are withheld or received by the employer, and (b) for welfare plans, 90 days from the date on which such amounts are withheld or received by the employer.

**Reporting of Late Remittances**

.239 Failure to remit or untimely remittance of participant contributions constitutes a prohibited transaction under ERISA Section 406, regardless of materiality. Such transactions constitute either a use of plan assets for the benefit of the employer or a prohibited extension of credit. In certain circumstances, such transactions may even be considered an embezzlement of plan assets.

.240 Information on all delinquent participant contributions should be reported on line 4a of either Schedule H, Financial Information, or Schedule I, Financial Information—Small Plan, of Form 5500, regardless of the manner in which they have been corrected. In addition, plan administrators should correct the prohibited transaction with the IRS by filing a Form 5330 and paying any applicable excise taxes.

.241 For large plans that are subject to the audit requirement:

- Delinquent participant contributions reported on line 4a that constitute prohibited transactions (excluding those that have been corrected under the VFCP and for which the conditions of Prohibited Transaction Exemption [PTE] 2002-51 have been satisfied, as described in the following) may be reported on a separate supplemental schedule to be attached to Form 5500 and reported on by the IQPA.

- ERISA and DOL regulations require additional information to be disclosed in supplemental schedules. Some of this information is required to be covered by the auditor’s report. AU section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, Professional Standards, vol. 1), provides guidance on the form and content of reporting when the auditor submits a document containing information accompanying the basic financial statements. If the auditor concludes that the plan has entered into a prohibited transaction and the transaction has not been properly disclosed in the required supplemental schedule, the auditor should (a) express a qualified opinion or an adverse opinion on the supplemental schedule if the transaction is material to the financial statements or (b) modify his or her report on the supplemental schedule by adding a paragraph to disclose the omitted transaction if the transaction is not material to the financial statements. See chapter 11, “Party in Interest Transactions,” of Audit and Accounting Guide *Employee Benefit Plans* for further discussion of prohibited transactions.

.242 Plan officials faced with remitting delinquent participant contributions should consider applying to the DOL’s VFCP. Plans that fully comply with the program, including satisfaction of the conditions of PTE 2002-51,

- will receive a no-action letter issued by the DOL that provides for no imposition of Section 502(l) penalties;
will receive relief from the excise tax provisions of the IRC;
will continue to report the occurrence and amount of the corrected delinquent remittances on line 4a of either Schedules H or I (but not on line 4d or Schedule G); and
are not required to report such transactions as supplemental information if the plan is required to be audited because the transactions are not considered to be prohibited transactions.


**Reporting of Delinquent Loan Repayments**

.244 Generally speaking, participant loan repayments are not subject to the DOL’s participant contribution regulation (29 CFR 2510.3-102). Accordingly, their delinquent remittance is not reported on line 4a of either Schedules H or I. However, delinquent remittance of participant loan repayments is a prohibited transaction.

.245 In Advisory Opinion 2002-2A, the DOL concluded that, although not subject to the participant contribution regulation, participant loan repayments paid to or withheld by an employer for purposes of transmittal to an employee benefit plan are sufficiently similar to participant contributions to justify, in the absence of regulations providing otherwise, the application of principles similar to those underlying the final participant contribution regulation for purposes of determining when such repayments become assets of the plan. Specifically, Advisory Opinion 2002-2A concluded that participant loan repayments paid to or withheld by an employer for purposes of transmittal to the plan become plan assets as of the earliest date on which such repayments can reasonably be segregated from the employer’s general assets.

.246 Accordingly, the DOL will not reject a Form 5500 report based solely on the fact that delinquent forwarding of participant loan repayments is included on line 4a of Schedules H or I. Filers that choose to include such participant loan repayments on line 4a must apply the same supplemental schedule and IQPA disclosure requirements to the loan repayments as apply to delinquent transmittals of participant contributions.

.247 Delinquent forwarding of participant loan repayments is eligible for correction under the VFCP and PTE 2002-51 on terms similar to those that apply to delinquent participant contributions.

**Proposed Safe Harbor for Employee Contributions to Small Pension and Welfare Plans**

.248 On February 29, 2008, the DOL announced a proposed rule to provide greater protection for employee contributions deposited to pension and welfare benefit plans with fewer than 100 participants by proposing a safe harbor period of 7 business days following receipt or withholding by employers. The proposal is designed to protect workers by encouraging employers to deposit participant contributions to small plans in a timely manner. It also will provide employers with a higher degree of compliance certainty.

.249 The proposed regulation may be viewed at the DOL’s Web site at www.dol.gov/ebsa.
The DOL Issues Final Rule on Investment Advice Exemption for 401(k) Plans and Individual Retirement Accounts

.250 On January 21, 2009, the DOL published a final rule to make investment advice more accessible for participants in 401(k) type plans and individual retirement accounts (IRAs). The rule includes a regulation that implements the new statutory exemption for investment advice added to ERISA by the PPA.

.251 The PPA amended ERISA by adding a new prohibited transaction exemption that allows greater flexibility for investment advisers to give advice to participants of 401(k) plans and IRAs. One of the ways in which investment advice may be given under the exemption is through the use of a computer model certified as unbiased; the other way is through an advisor compensated on a level-fee basis. Several other requirements also must be satisfied, including disclosure of fees the advisor is to receive.

.252 The final regulation provides general guidance on the exemption’s requirements, including computer model certification and disclosures by fiduciaries. The regulation also includes a model form to assist advisors in satisfying the exemption’s fee disclosure requirement. In addition, the final rule includes a class exemption expanding the availability of investment advice.

.253 The final rule may be viewed at www.dol.gov/ebsa/pensionreform.html.

New Civil Penalty Rules Regarding Disclosures to Participants (ERISA Section 502[c][4])

.254 On January 2, 2009, the DOL published a final regulation under ERISA Section 502(c)(4), implementing the department’s authority to assess civil penalties against plan administrators who fail to disclose certain documents to participants, beneficiaries, and others as required by ERISA, as amended by the PPA.

.255 The PPA established new disclosure provisions relating to funding-based limits on benefit accruals and certain forms of benefit distributions; plan actuarial and financial reports; withdrawal liability of contributing employers; and participants’ rights and obligations under automatic contribution arrangements. The PPA gives the DOL authority to assess civil monetary penalties of up to $1,000 per day against plan administrators for violations of the new disclosure requirements. The proposed regulation sets forth the administrative procedures for assessing and contesting such penalties and does not address substantive provisions of the new disclosure requirements.

.256 The text of the final regulation is available on the EBSA’s Web site at www.dol.gov/ebsa.

The DOL Issues Final Rule for Distributions to Missing Nonspouse Beneficiaries

.257 On October 7, 2008, the DOL issued a final rule requiring the distribution of 401(k) type benefits for missing nonspouse beneficiaries from terminated plans to be rolled into IRAs.

.258 The PPA amended the IRC to allow the rollover of certain retirement benefits of a deceased participant into a tax-favored inherited IRA created on behalf of a nonspouse beneficiary.

.259 The new rule (and a related class exemption), conforms to the PPA by amending existing distribution requirements for terminated defined contribution plans, including abandoned plans, to require rollovers into inherited IRAs for missing nonspouse beneficiaries.

.260 The final rule and model notices for notifying participants or beneficiaries of the plan’s termination and distribution options may be found at www.dol.gov/ebsa/regs.
The DOL Issues Final Rules on Selecting Annuity Providers for Benefit Distributions From Pension Plans

.261 On October 7, 2008, the DOL published two final rules on selection of annuity providers. One rule limits the application of the “safest available” standard of Interpretative Bulletin 95-1 to defined benefit plans. The rule limits the application of the bulletin to the selection of annuity providers for benefit distributions from defined benefit plans.

.262 The DOL also announced a final regulation to provide guidance, in the form of a safe harbor, for the selection of annuity providers by fiduciaries for benefit distributions from individual account plans, such as 401(k) plans.

.263 The final rules may be viewed at www.dol.gov/ebsa/regs.

The DOL Issues Final Rule on Cross Trading

.264 On October 7, 2008, the DOL published a final rule regarding the new statutory exemption on cross-trading in the PPA.

.265 The rule implements a key provision of the PPA that allows plans to benefit from cross-trading, while ensuring that fair and equitable procedures are in place to protect workers’ retirement assets. Cross-trading is a transaction in which an investment manager uses its authority to sell a security on behalf of one client and to buy that same security on behalf of another client.

.266 The statutory exemption allows investment managers of plans governed by ERISA to execute cross-trades if certain conditions are met, including the adoption of written cross-trading policies and procedures. The rule establishes the requirements for the policies and procedures investment managers must adopt to engage in cross-trades.

.267 The rule may be found at www.dol.gov/ebsa/regs.

The DOL Proposes Regulations to Improve Disclosure of Fees and Expenses to Workers With 401(k)-Type Benefit Plans

.268 On July 23, 2008, the DOL published a proposed rule that will make it easier for workers covered by 401(k)-type plans to make informed retirement savings decisions by providing them with useful summary information, including fee and expense information, for investment options available under their plans.

.269 The centerpiece of the proposed regulation is a requirement to provide investment-related information in a comparative chart or similar format. As part of the proposal, the DOL has developed a model chart for complying with this requirement, while giving plan fiduciaries the flexibility to design their own charts or comparative formats.

.270 The proposal would also require plan fiduciaries to disclose basic information about the plan and its investment options, such as what options are available under the plan, how to give investment instructions, investment returns, fees and expenses, and how to obtain more detailed information. This information would be given to participants on a regular and periodic basis.

.271 The proposed rule and model comparative chart are available at www.dol.gov/ebsa.
The DOL Issues Guidance on Reporting Service Provider Fee and Compensation Information (Schedule C) Reporting for 2009 Form 5500

.272 On July 14, 2008, the DOL published guidance to help plan administrators and service providers comply with the new requirements for reporting service provider fee and compensation information applicable to Form 5500 filed for plan years beginning on or after January 1, 2009.

.273 The EBSA released 40 FAQs developed in response to questions from the employee benefit community on the new Schedule C requirements. The FAQs cover such issues as the alternative reporting option for eligible indirect compensation; electronic disclosure of fee information by service providers; fee reporting for brokerage window options in participant directed plans; and reporting on gifts, entertainment, and other nonmonetary compensation.

.274 In response to concerns expressed by service providers trying to make changes to their recordkeeping and information management systems in order to provide their employee benefit plan clients with fee and compensation information required for 2009 reports, the department is not requiring plan administrators to report service providers on the Schedule C as failing to provide fee and compensation information if the service provider furnishes the plan administrator with a written statement that (a) the service provider made a good faith effort to make any necessary recordkeeping and information system changes in a timely fashion and (b) despite such efforts, the service provider was unable to complete the changes for the 2009 plan year.

.275 The FAQs on Schedule C reporting can be found at www.dol.gov/ebsa.

Multiemployer Plan Notices

The DOL Issues Model Notice for Multiemployer Plans in Critical Status

.276 On March 25, 2008, the DOL published a proposed regulation providing a model notice for use by multiemployer defined benefit pension plans to notify plan participants and others that their plan is in critical funding status. The proposed regulation is the result of the PPA.

.277 The PPA amended ERISA and the IRC to require that sponsors of multiemployer defined benefit pension plans in critical status for a plan year provide notice of this status to participants, beneficiaries, the bargaining parties, the PBGC, and the DOL. The PBGC, created under ERISA to insure defined benefit pension plans, guarantees payment of basic pension benefits of affected workers and retirees.

.278 The notice must inform participants that their plan is in critical status and of the possibility that adjustable benefits may be reduced or even eliminated. The proposed regulation contains a model notice that may be used by plans to satisfy the notice requirement.

.279 The proposed regulation may be found at the DOL Web site at www.dol.gov/ebsa.

Multiemployer Plan Notice

.280 Sections 202 and 212 of the PPA established new funding requirements for multiemployer plans deemed to be in an endangered or critical status. No later than the 90th day of each plan year, an actuary is required to certify to the Treasury and the plan sponsor both of the following:

- Whether or not a plan is in endangered status for the plan year and whether or not the plan is or will be in critical status for the plan year

- In the case of a plan that is in a funding improvement or rehabilitation period, whether or not the plan is making the scheduled progress in meeting the requirements of its funding improvement or rehabilitation plan
Plans in “critical” status must include in the notice additional explanations regarding possible reduction of adjustable benefits.

No later than 30 days after a multiemployer plan is certified to be in endangered or critical status, the plan sponsor must provide notice of the endangered or critical status to participants and beneficiaries, the bargaining parties, the PBGC, IRS, and DOL.

An actuary’s failure to timely certify a plan’s status is equivalent to the plan sponsor having failed to file a Form 5500. This subjects the plan administrator to penalties of up to $1,100 per day pursuant to ERISA Section 502(c)(2). Also, pursuant to ERISA Section 502(c)(8), the plan administrator is subject to penalties of up to $1,100 per day for not adopting a funding or rehabilitation plan.

This requirement is effective for plan years beginning after 2007.

EBSA’s Final Rule on Default Investment Alternatives for Participant-Directed Plans

On October 24, 2007, the DOL published a final rule in the Federal Register establishing qualified default investment alternatives, making it easier for employers to automatically enroll workers in their 401(k) and other defined-contribution plans. The PPA directed the DOL to issue a regulation to assist employers in selecting default investments that best serve the retirement needs of workers who do not direct their own investments.

By facilitating the adoption of automatic enrollment plans, and by encouraging investments appropriate for long-term retirement savings, the DOL estimates the rule will result in between $70 billion and $134 billion in additional retirement savings by 2034.

Overview of the Final Regulation

The final regulation provides the following conditions that must be satisfied in order to obtain safe harbor relief from fiduciary liability for investment outcomes:

- Assets must be invested in a QDIA as defined in the regulation.
- Participants and beneficiaries must have been given an opportunity to provide investment direction, but have not done so.
- A notice generally must be furnished to participants and beneficiaries in advance of the first investment in the QDIA and annually thereafter. The rule describes the information that must be included in the notice.
- Material, such as investment prospectuses, provided to the plan for the QDIA must be furnished to participants and beneficiaries.
- Participants and beneficiaries must have the opportunity to direct investments out of a QDIA as frequently as from other plan investments, but at least quarterly.
- The rule limits the fees that can be imposed on a participant who opts out of participation in the plan or who decides to direct their investments.
- The plan must offer a “broad range of investment alternatives” as defined in the DOL’s regulation under Section 404(c) of ERISA.

The final regulation does not absolve fiduciaries of the duty to prudently select and monitor the QDIAs.
Qualified Default Investment Alternatives

.289 The final regulation does not identify specific investment products—rather, it describes mechanisms for investing participant contributions. The intent is to ensure that an investment qualifying as a QDIA is appropriate as a single investment capable of meeting a worker’s long-term retirement savings needs. The final regulation identifies two individually-based mechanisms and one group-based mechanism—it also provides for a short-term investment for administrative convenience.

.290 The final regulation provides for four types of QDIAs:

- A product with a mix of investments that takes into account the individual’s age or retirement date (an example of such a product could be a life-cycle or targeted-retirement-date fund)
- An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual’s age or retirement date (an example of such a service could be a professionally managed account)
- A product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual (an example of such a product could be a balanced fund)
- A capital preservation product for only the first 120 days of participation (an option for plan sponsors wishing to simplify administration if workers opt-out of participation before incurring an additional tax)

.291 A QDIA must either be managed by an investment manager, plan trustee, or plan sponsor who is a named fiduciary, or be an investment company registered under the Investment Company Act of 1940.

.292 A QDIA generally may not invest participant contributions in employer securities.

Other Significant Provisions

.293 Recognizing that some plan sponsors adopted stable value products as their default investment prior to passage of the PPA and this final regulation, the regulation provides a transition rule. The regulation grandfathers these arrangements by providing relief for contributions invested in stable value products prior to the effective date of the final rule. The transition rule does not provide relief for future contributions to stable value products.

.294 The final regulation clarifies that a QDIA may be offered through variable annuity contracts or other pooled investment funds.

.295 The rule provides that ERISA supersedes any state law that would prohibit or restrict automatic contribution arrangements, regardless of whether such automatic contribution arrangements qualify for the safe harbor.

.296 A copy of the regulation and a fact sheet detailing the rule may be found at the DOL’s Web site at www.dol.gov/ebsa/regs.

Civil Penalty Rules For Failure to Provide Diversification Notices (ERISA Section 502[c][7])

.297 On August 10, 2007, the DOL published a direct final rule amending the civil penalty regulation under ERISA Section 502(c)(7) to reflect amendments to this section in the PPA. The final regulation implements the DOL’s authority to assess civil penalties against plan administrators who fail to give employees notice of the right to sell company stock in their pension plan accounts.
.298 The PPA established rights of plan participants and beneficiaries to sell the company stock in their accounts and reinvest the proceeds into other investments available under a plan. It also required plan administrators to notify participants and beneficiaries of this new right and of the importance of diversifying the investment of retirement account assets.

.299 The amendments authorize the DOL to assess civil monetary penalties against plan administrators who fail to give employees notice of the right to sell company stock in their pension plan accounts. These penalties may range as high as $100 per day against plan administrators for each violation of the new notice requirement.

.300 The new rule may be found at the DOL’s Web site at www.dol.gov/ebsa.

Investments Reported as 103-12 Entities as Required by the DOL

.301 For many years, the EBSA has focused attention on the valuation of hard-to-value assets (currently, more commonly referred to as alternative investments). This year, the EBSA is looking at alternative investments held by plans and master trusts where these investments have not been subject to plan audit procedures.

.302 Due to the current economic crisis and the recent developments involving financial frauds in managed investment funds, the agency is expanding its scope to consider the current status of the investments being reviewed. EBSA plans to emphasize its focus on how plan management determines that investments exist and that their values have been adjusted to reflect the current market conditions.

EBSA Technical Guidance

Field Assistance Bulletins

.303 In the course of audits and investigations by EBSA field enforcement staff, difficult legal issues often arise. In an effort to provide the regional office staff with prompt guidance, the EBSA has developed a vehicle for communicating technical guidance from the national office. Field Assistance Bulletins (FABs) ensure that the law is applied consistently across the various regions. They also provide the regulated community with an important source of information about the EBSA’s views on technical applications of ERISA. All the FABs are posted on the EBSA’s Web site and available to the public. Currently, 21 FABs are outstanding. They cover many topics of current interest such as refinancing ESOP loans (FAB 2002-1), ERISA rules on participant loans where securities law might otherwise limit such loans (FAB 2003-1), duties to lost participants in a terminated plan (FAB 2004-2), interaction between IRS rules and DOL provisions for 403(b) plans (FAB 2007-2), and the responsibilities for ERISA fiduciaries to collect delinquent contributions (FAB 2008-1).

Help Desk—The FABs are available at www.dol.gov/ebsa/regs/fabmain.html.

Exempt Transaction Opinions

.304 Auditors are required to perform certain procedures with respect to party-in-interest transactions under chapter 11 of Audit and Accounting Guide Employee Benefit Plans. It is frequently difficult to assess whether a particular transaction is exempt from the prohibited transaction rules of ERISA. EBSA provides some assistance in that area with respect to common transactions through granting class exemptions for specific business relationships between a plan and a party-in-interest. These are referred to as prohibited...
transaction class exemptions (PTCE). A complete, searchable list of such transactions is available on EBSA’s Web site.

**Help Desk**—PTCEs are available at www.dol.gov/ebsa/Regs/ClassExemptions/main.html.

**Advisory Opinions**

.305 EBSA uses the advisory opinion program to provide fairly rapid responses to timely questions that are not part of a regulation project such as the AICPA’s 2002 request for clarification on the treatment of participant loan repayments under the plan asset regulations (DOL Advisory Opinion 2002-2a). Opinions issued since 1999 are summarized on EBSA’s Web site for easy research.

**Help Desk**—Advisory opinions are available at www.dol.gov/ebsa/Regs/AOs/main.html.

**Recent AICPA Independence and Ethics Pronouncements**

.306 Audit Risk Alert *Independence and Ethics Developments—2008* (product no. 022479kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

**On the Horizon**

.307 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to employee benefit plans or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.308 The following table lists the various standard setting bodies’ Web sites, through which information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard setting bodies for further information.

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<tr>
<th>Standard-Setting Body</th>
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(continued)
Overhaul Project—AICPA Audit and Accounting Guide Employee Benefit Plans

.309 The AICPA is continuing to make progress overhauling the AICPA Audit and Accounting Guide Employee Benefit Plans, addressing numerous accounting, auditing, industry, and regulatory issues that have transpired since this guide was originally issued in 1991. During this project, the AICPA will continue to issue annual editions of the guide, updated to reflect recent audit and accounting pronouncements.

Auditing Pipeline—Nonissuers

ASB Clarity Project

.310 In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the next two or three years, the ASB will be redrafting all of the existing auditing sections contained in the Codification of Statements on Auditing Standards (AU sections of the AICPA’s Professional Standards) to apply the clarity drafting conventions and converge with the International Standards on Auditing issued by the International Auditing and Assurance Standards Board (IAASB). The ASB proposes that, except to address current issues, all redrafted standards will become effective at the same time. Only those standards needing to address current issues would have earlier effective dates. The ASB believes that a single effective date will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. Currently, the date is expected to be for audits of financial statements for periods beginning no earlier than December 15, 2010. This date depends on satisfactory progress being made, and will be amended should that prove necessary. See the explanatory memorandum “Clarification and Convergence” and the discussion paper Improving the Clarity of ASB Standards at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm.

Auditing Pipeline—Issuers

PCAOB Risk Assessment Standards

.311 In October 2008, the PCAOB proposed seven new auditing standards to update and supersede the current risk assessment standards. The PCAOB chairman noted that the proposals demonstrate the view that the risk of fraud is a central part of the audit process and not a separate consideration. The proposed standards integrate the risk assessment standards with the standard for the audit of internal control over financial reporting. In February 2009, the CAQ issued a comment letter on the proposed standards. Readers can review the full text of the comment letter at http://thecaq.org/newsroom/pdfs/CAQCommentLetter-PCAOBRiskAssessmentAuditStds.pdf. The comment period for these proposed standards ended February 2009. As with any new auditing standard or amendment to a PCAOB standard, after adoption by the PCAOB the standards will be submitted to the SEC for approval.

Engagement Quality Review

.312 In March 2009, the PCAOB reproposed an auditing standard on engagement quality review for public comment. The PCAOB made substantial changes to the proposed auditing standard since it was first proposed.
in February 2008. The proposal would supersede the PCAOB’s current audit quality control standard and would apply to all audit engagements and engagements to review interim financial information conducted pursuant to the standards of the PCAOB. The proposed standard provides a framework for an engagement quality reviewer to objectively evaluate the significant judgments made by the engagement team and the conclusions reached in forming an overall conclusion about the engagement.

Accounting Pipeline

.313 FASB has the following projects underway that may affect employee benefit plans:

- Going concern
- Subsequent events
- Credit crisis projects that include the following:
  - Measuring liabilities under FASB Statement No. 157
  - Embedded credit derivatives scope exceptions
  - Determining when a market for an asset or liability is active or inactive and determining when a transaction is distressed
  - Improving disclosures about fair value measurements
  - Applying fair value to interests in alternative investments
- Phase 2 of the applicability of FIN 48 for private entities (FIN 48 is codified at FASB ASC 740, Income Taxes)
- An amendment to FASB Statement No. 162, The Hierarchy of Generally Accepted Accounting Principles, and approval of FASB ASC
- Disclosure of certain loss contingencies
- Phase 2 of postretirement benefit obligations, including pensions

Employee Benefit Plan Resources

.314 The following are various resources that practitioners engaged in the employee benefit plan industry may find beneficial.

AICPA Employee Benefit Plan Audit Quality Center

.315 The AICPA EBPAQC, a firm-based, voluntary membership center with the goal of promoting quality employee benefit plan audits, celebrated its fifth anniversary in March. An indicator of the EBPAQC’s success comes from the DOL, which is finding through its audit quality monitoring program a demonstrable difference between the quality of audits performed by EBPAQC firms and those audits performed by nonmembers. Reviews performed by the DOL’s EBSA continue to show fewer audit deficiencies in audits performed by EBPAQC member firms. In addition, where deficiencies are noted they tend to be less severe for EBPAQC member firms.

.316 As members of the EBPAQC, firms have available to them tools and resources that are not available from any other source. In addition to providing periodic e-alerts with information about recent developments affecting employee benefit plan audits, the EBPAQC has recently made available to its members

- new resource centers, including a plan investments resource center that includes valuable new tools and resources to help auditors and plan sponsors understand and implement FASB Statement No. 157, and a health and welfare plan resource center that centralizes resources useful to auditors of those plans.

3 See footnote 1.
live forum, member-only conference calls to share important information and answer participant questions on a wide range of technical and practice topics. These calls are free to members, and as an added benefit, the EBPAQC offers a continuing professional education (CPE) option for a small fee.

new tools to help sponsors of 403(b) plans now subject to audit understand what questions they may expect from their plan auditors and what information they might be expected to provide.

a “Topix” primer on alternative investments in employee benefit plans to help members gain a general understanding of these types of investments.

Visit the EBPAQC Web site at www.aicpa.org/ebpaqc to see a complete list of the more than 1,700 EBPAQC members and to preview benefits. For more information, contact the EBPAQC at ebpaqc@aicpa.org.

Resource Central

The following are various resources that practitioners auditing employee benefit plans may find beneficial.

Publications

Practitioners may find the following publications useful. Choose the format best for you—online, print, or CD-ROM.

- Audit and Accounting Guide Employee Benefit Plans (2009) (product no. 012599kk [paperback], WEBXX12 [online], or DEBXX12 [CD-ROM])
- Audit Guide Analytical Procedures (2008) (product no. 012558kk [paperback], WAN-XX [online], or DAN-XX [CD-ROM])
- Audit Guide Auditing Derivative Instruments, Hedging Activities, and Investments in Securities (2008) (product no. 012528kk [paperback], WDI-XX [online], or DDI-XX [CD-ROM])
- Audit Guide Audit Sampling (2008) (product no. 012538kk [paperback], WAS-XX [online], or DAS-XX [CD-ROM])
- Audit Guide Service Organizations: Applying SAS No. 70, As Amended (2008) (product no. 012779kk [paperback], WSV-XX [online], or DSV-XX [CD-ROM])
- Audit Risk Alert Current Economic Crisis: Accounting and Auditing Considerations—2009 (product no. 0223308kk [paperback], WGE-XX [online], or DGE-XX [CD-ROM])
- Audit Risk Alert Independence and Ethics Developments—2008 (product no. 022479kk [paperback], WIA-XX [online], or DIA-XX [CD-ROM])
- Audit Risk Alert Understanding the New Auditing Standards Related to Risk Assessment (product no. 022526kk [paperback])
- Audit Risk Alert Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115 (product no. 022539 [paperback])
- Checklists and Illustrative Financial Statements for Defined Benefit Pension Plans (product no. 008998kk [paperback] or WDB-CL [online])
- Checklists and Illustrative Financial Statements for Defined Contribution Pension Plans (product no. 009008kk [paperback] or WDC-CL [online])
- Checklists and Illustrative Financial Statements for Health and Welfare Benefit Plans (product no. 009018kk [paperback] or WHW-CL [online])
- Accounting Trends & Techniques, 62nd Edition (product no. 009900kk [paperback] or WAT-XX [online])
• Accounting Trends & Techniques—Employee Benefit Plans, 2nd Edition (product no. 006651kk [paperback])
• Audit and Accounting Manual (2008) (product no. 005138kk [paperback], WAM-XX [online], or AAM-XX [loose leaf])
• AICPA Audit Practice Aid SAS No. 70 Reports and Employee Benefit Plans (product no. 061061kk [paperback or CD-ROM])

.320 Additional resources for accountants in business and industry are the Financial Reporting Alert series, designed to be used by members of an entity’s financial management and audit committee to identify and understand current accounting and regulatory developments affecting the entity’s financial reporting.

• Financial Reporting Alert FASB Codification Developments—2008 (product no. 029209kk [paperback])
• Financial Reporting Alert Not-for-Profit Organizations: Accounting Issues and Risks—2008 (product no. 029207kk [paperback])

AICPA reSOURCE: Accounting and Auditing Literature

.321 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm’s needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to the AICPA’s latest Professional Standards, Technical Practice Aids, Audit and Accounting Guides, Audit Risk Alerts, Accounting Trends & Techniques, and more. To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

Continuing Professional Education

.322 The AICPA offers a number of CPE courses that are valuable to CPAs working in public practice and industry. Among the many courses, the following are specifically related to employee benefit plans:

• Audits of 401(k) Plans
• Employee Benefit Plans Audit and Accounting Essentials
• Form 5500: Prepare It Fast—File It Right...The 1st Time
• SAS No. 70 Auditing Guidance

.323 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.324 AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA’s flagship online learning product. AICPA members pay $180 for a new subscription and $149 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics.

.325 To register or learn more, visit www.cpa2biz.com.

Webcasts

.326 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession’s leading experts. Broadcast live, they allow you to interact with the presenters and join the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.
In particular, Employee Benefit Plans Strategic Briefing has been archived and is available on demand. This webcast, held on April 22, 2009, was a live interactive AICPA webcast covering all the hot issues currently affecting employee benefit plans. Participants learned about current accounting, auditing, and regulatory developments, including the effect of recently issued pronouncements on both preparers and auditors of employee benefit plans. Speakers included Marcus J. Aron, CPA; Marilee Lau, CPA; and Michele Weldon, CPA.

Member Service Center

To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA’s Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/.

Ethics Hotline

In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA’s Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

Industry Conferences

The AICPA sponsors an annual Employee Benefit Plans Accounting, Auditing and Regulatory Update Conference in the late fall. This conference is a two-day high level forum that lets you interact with expert auditors and members of the DOL. The 2009 conference will be held December 7–8, 2009.

The AICPA also sponsors an annual National Conference on Employee Benefit Plans each spring. This conference is designed to update attendees on recent developments related to employee benefit plans. The 2010 conference will be held in May 2010. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

AICPA Industry Expert Panel—Employee Benefit Plans


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This Audit Risk Alert replaces Employee Benefit Plans Industry Developments—2008.

The Audit Risk Alert Employee Benefit Plans Industry Developments is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year’s Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to ldelahanty@aicpa.org or write to
Linda C. Delahanty, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110
### Appendix A—IRS Limits

<table>
<thead>
<tr>
<th>Plan Type</th>
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<tr>
<td><strong>Defined Benefit Plans</strong></td>
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<td>$180,000</td>
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<td>Maximum elective deferral</td>
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<td>15,500</td>
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<td><strong>403(b) Plan</strong></td>
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<td><strong>SIMPLE Plans</strong></td>
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<td><strong>Qualified Plans</strong></td>
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<td>Highly compensated limits</td>
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<td>Officer limits (key employee)</td>
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<td>Act taxable wage base</td>
<td>6.2%</td>
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Appendix B—Definitions of Certain Investments

The following list includes certain investments as defined by the instructions to the Form 5500, Annual Return/Report of Employee Benefit Plan.

**master trust.** A trust for which a regulated financial institution (bank, trust company, or similar financial institution that is regulated, supervised, and subject to periodic examination by a state or federal agency) serves as trustee or custodian and in which assets of more than one plan sponsored by a single employer or by a group of employers under common control are held.

**common/collective trust (CCT).** A trust maintained by a bank, trust company, or similar institution that is regulated, supervised, and subject to periodic examination by a state or federal agency for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer or a controlled group of corporations.

**pooled separate account (PSA).** An account maintained by an insurance carrier, which is regulated; supervised; and subject to periodic examination by a state agency, for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer or a controlled group of corporations.

**103-12 Entity.** An entity that is not a master trust, CCT, or PSA whose underlying assets include plan assets within the meaning of 29 U.S. Code of Federal Regulations 2510.3-101 of 2 or more plans that are not members of a related group of employee benefit plans.

**registered investment company.** An investment firm that is registered with the Securities and Exchange Commission and complies with certain stated legal requirements for the collective investment and reinvestment of assets contributed thereto from investors (employee benefit plans and nonemployee benefit plans).
Appendix C—Auditing Health and Welfare Plans

This section is intended to describe certain audit challenges unique to health and welfare benefit plans and how these challenges cause health and welfare plans to be more complex and expensive to audit than other types of benefit plans. The operations surrounding the administration of health claims payments have always been complex and difficult for auditors to fully understand and document. The requirements for more timely claims processing, appeal decisions, and the privacy requirements under the Health Insurance Portability and Accountability Act of 1996 (HIPAA) have added to the complexity and therefore, the difficulty.

HIPAA Privacy Concerns

HIPAA established standards for the privacy and protection of individually identifiable electronic health information as well as administrative simplification standards. HIPAA includes protection for those who move from one job to another, are self-employed, or have preexisting medical conditions. It places requirements on employer-sponsored group health plans, insurance companies, and health maintenance organizations.

The rules include standards to protect the privacy of individually identifiable health information. The rules (applicable to health plans, health care clearinghouses, and certain health care providers, known collectively as “covered entities”) present standards with respect to the rights of individuals who are the subjects of this information, procedures for the exercise of those rights, and the authorized and required uses and disclosures of this information. These are the first-ever national standards to protect medical records and other personal health information.

Business Associates’ Agreements

HIPAA requires that plan sponsors enter into a business associates’ agreement (BAA) with any of their service providers that have access to any protected health information (PHI). Accordingly, an auditor is considered a business associate and, after entering into a BAA, should be permitted access to the necessary information required by professional standards to opine on a plan’s financial statements. When asked to sign a BAA, auditors need to take special care in reviewing the agreement.

Help Desk—The American Recovery and Reinvestment Act of 2009 (ARRA) includes changes to HIPAA. In the past, HIPAA was only applicable to the use and disclosure of the PHI by covered entities. Vendors who provided administrative services to covered entities (for example, those providing legal, accounting, IT, financial support, or other similar services) were required to sign BAAs, which, by contract, they then agreed to maintain the privacy and security of the PHI. However, under the ARRA, several of the HIPAA security and privacy requirements have been expanded, including business associates being subject to civil and criminal penalties and enforcement proceedings for violations of HIPAA.

For more information on the ARRA’s changes to HIPAA, including data restrictions, disclosure and reporting requirements as well as various applicable effective dates, see www.rules.house.gov/111/legtext/111_hr1_text.pdf.

Nondisclosure Agreements

Sponsors of health and welfare plans frequently hire third party administrators (TPAs) to perform administrative functions for their plans, such as administration of participant claims. Generally, the plan auditor tests a sample of claims processed by the TPA as part of the audit. As a result, confidential information generally is exchanged. Before agreeing to provide this proprietary information and data, TPAs frequently request the plan sponsor or auditor, or both, to sign confidentiality agreements or nondisclosure agreements (NDAs). As
with business associates agreements, auditors need to take special care in reviewing nondisclosure agreements. Often, the auditor may not agree with certain language in the agreement, resulting in delays in the audit until mutually agreeable language is determined.

**Help Desk**—NDAs can take many forms and arise on the audit of all types of plans. For example, some TPAs require the auditor to agree to the terms of an NDA prior to being permitted limited access to electronic databases needed to obtain audit evidence directly from the TPA’s Web site. Acceptance of these terms would constitute an NDA.

**Audit Documentation**

As previously noted, HIPAA requires that plan sponsors enter into a business associates’ agreement with any of their service providers that have access to the PHI. Accordingly, an auditor is considered a business associate and, after entering into a business associates agreement, should be permitted access to the necessary information required by professional standards to opine on a plan’s financial statements. HIPAA regulations allow for the auditors’ working papers to contain the PHI; however, the PHI in working papers obligates the auditing firm to comply with the HIPAA privacy laws and business associates agreement provisions to maintain the privacy of the PHI, which includes

- restricting access to the working papers,
- providing an accounting of disclosures of the PHI, and
- reporting to plan management any misuse of the PHI by the accounting firm.

AU section 339, Audit Documentation (AICPA, Professional Standards, vol. 1), provides guidance to auditors on documentation requirements. See paragraphs 5.80–.87 of Audit and Accounting Guide Employee Benefit Plans for guidance.

“De-identified” health information is not subject to HIPAA. To be considered de-identified under HIPAA, information in working papers may not contain the following:

- Names
- Dates (such as birth date, admission date, discharge date, and date of death)
- Age, if age 90 or older
- Complete social security numbers¹
- Telephone and fax numbers
- E-mail addresses
- Medical record numbers
- Health plan beneficiary numbers
- Account numbers

**Considerations When Planning a Health and Welfare Plan Audit**

Before performing a health and welfare plan audit, it is critical for the auditor to obtain a clear understanding of the plan. Plan sponsors commonly wrap multiple benefits together into a single plan entity, and don’t always run the contribution and distribution activity for every benefit through a trust (for example, the contributions and premiums associated with insured life benefits are frequently processed through the general assets of the sponsor). In addition, given that many health and welfare plan benefits are negotiated annually, items such as eligibility criteria and benefit coverage can change from year to year. Because the majority of today’s TPAs utilize systems focused on automation and speed, a key element in the claims administration

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¹ Including complete social security numbers in working papers is not permissible under HIPAA. Auditors should consider blocking out all digits except the last four in a social security number if this information is necessary for identification purposes.
process is the proper accumulation and installation of plan data by the TPA. Plan data includes, but is not limited to, key benefit provisions, participant information, providers (both network and nonnetwork), and rate structure. Once the TPA has compiled the information and has input it into their system, plan management should ensure they have controls in place to review all key plan parameters input into the TPA system.

When planning a health and welfare plan audit, the auditor needs to have a clear understanding of the following:

- Which plan benefits are fully insured versus self-insured
- The identity of the plan’s various benefit providers and the elements of the contractual arrangements between the plan and those providers
- For self-insured claims:
  - How and by whom the various claims are administrated and adjudicated
  - How administrative fees are charged by the provider
  - Whether the benefit payment is accounted for by the provider when the check is written, when the check is presented for payment, or when the check has cleared the bank
- For insured benefits, how the premiums are determined and billed and if the contract requires or provides for premium stabilization reserves or experience-rated adjustments
- The funding arrangements for the plan and which benefits are employer paid versus participant paid, and how associated contributions are calculated, accumulated, and remitted or utilized to pay benefits
- If benefits paid from a trust (like a voluntary employees’ beneficiary association [VEBA] trust or a taxable trust), a 401(h) account, or from the general assets of the plan’s sponsor
- The frequency of benefit payments (daily, monthly, quarterly, or annually)
- Information systems used to support the plan operations and which systems are in-house systems versus outsourced

While gaining their understanding of the preceding, it is recommended that auditors consider the responses with regard to all covered participants. All covered participants include active participants, former employees under the Consolidated Omnibus Budget Reconciliation Act (COBRA), eligible dependents of active and former employees, and retirees. Understanding the various benefits offered, the service providers, the various transaction flows and related control environment is integral to developing the audit approach and the sampling methodology. Standard audit programs for employee benefit plans should be tailored to the unique nature of health and welfare plans.

Unique Health and Welfare Plan Audit Areas

This section is intended to describe certain unique audit areas specific to health and welfare plans and in certain instances to provide examples of audit procedures.

Claims and Potential Problems

When auditing claims, it is not expected that the auditor would have the knowledge of a skilled billing claims specialist or a skilled medical specialist when claims are processed by a third-party administrator. It is important, however, that the auditor has a basic understanding of the terms of the plan and has the skill and knowledge to test that claims are being properly adjudicated. The auditor may want to be aware of any processing problems that the plan is experiencing with claims and discuss what the plan is doing to correct these issues with the plan administrator. Examples of potential problems when processing claims include

- unbundling (charging for performance of multiple procedures when only one procedure was performed or should be billed per American Medical Association guidelines) or upcoding (charging for a higher level of service than the procedure actually performed),
- fictitious services or unnecessary services performed by providers,
• duplicate claims or duplicate coverage,
• kickbacks,
• nontransmittal of rebates and discounts to the plan, and
• improper denial of claims.

When testing health and welfare claims, some errors typically found include the following:

• **Eligibility.** Most problems with eligibility relate to a participant who terminates and whose eligibility ceased before the date of service for which the claim was filed. Note that the testing for eligibility is different from those procedures for a pension or 401(k) plan. In many cases, the person receiving the benefit is different from the actual participant. Audit procedures may include verifying the coverage elected by the participant at the date of service. Many plans allow coverage for a spouse, dependents, or other family members.

• **Wrong individual.** The claim was paid for the wrong person. This occurs when two or more participants have the same or similar names. Claims may also be paid for the wrong family member.

• **Deductibles.** Deductibles are not calculated properly.

• **Accumulators.** Benefits are improperly totaled, which may cause the benefit amount to improperly exceed the maximum benefit.

• **Other errors.** Errors may occur in the diagnosis code, the Current Procedural Terminology or Healthcare Common Procedure Coding System code, or in the information in the claims form.

**Contracts With Benefit Service Providers**

For any contract with a benefit service provider, the auditor may examine the reconciliation of the amounts due to or from the benefit service provider to determine if the amounts are appropriate. Any amounts due from the benefit provider are typically classified as a receivable in the statement of net assets, and amounts due to the provider for benefits paid would normally be shown in the financial statements as a liability on the statement of net assets. If the benefit payment has not been disbursed by any party, then the amount would typically be included with benefit obligations of the plan. The auditor may want to consider the role played by the TPA. Often, the TPA directly pays the claim and then the plan reimburses the TPA. If the TPA pays the claim, then the claim would be recorded as benefits paid and a “due to the TPA” liability may need to be recorded on the statement of net assets.

**Rebates Receivable**

If rebates receivable from a service provider exist, the auditor may examine those rebates to determine if the correct amount for the appropriate period of time has been properly reflected in the financial statements. In addition, the auditor may gain an understanding of the service contracts and apply procedures to determine if all rebates have been received by the plan. These include rebates from prescription drug programs or excess premiums paid over claims incurred under certain contractual arrangements with insurance companies. The auditor would also consider the propriety of the rebate. For example, if the payment vehicle for the claims receiving the rebate was the VEBA trust account, receipt of the rebate by the plan sponsor, and deposit of such rebate into a nontrust account may not be appropriate.

**Accumulated Eligibility Credits**

Many plans cover participants when they are terminated or otherwise unemployed. Single employer plans often cover up to 30 days after employment ends. Multiemployer plans can cover up to 60 days or longer after employment ends. In the construction industry, where work is seasonal, hour banks are often used to provide insurance coverage for the months when the participant does not work. If the plan permits accumulated eligibility credits, there should be an obligation recorded for those credits. The auditor may determine whether the plan provides for accumulated eligibility credits and, if so, if the obligation has been properly calculated.

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2 Physicians’ Current Procedural Terminology (CPT) is a listing of descriptive terms and identifying five-digit codes for reporting medical services and procedures. The Health Care Financing Administration developed level II and level III codes in its Healthcare Common Procedure Coding System to bill for supplies and services not covered by a CPT code (level I).
Actuarial Data and Census Information

The actuarial data and census information furnished by the health and welfare plan sponsor to the actuary, especially when the plan covers retirees, is as important as the data used in a defined benefit pension plan. The auditor may gain assurance through confirmation or other audit procedures that the actuarial data and census information furnished to the actuary is complete and accurate.

Stop-Loss Coverage

One way for a plan to protect itself against excessive losses is to purchase stop-loss insurance. Stop-loss insurance can be either specific or aggregate. Specific stop-loss insurance protects the plan against claims that exceed a predetermined maximum per person or per family. All claims above the specific stop-loss amount (for example, $100,000) are normally reimbursed to the plan at 100 percent up to a limit contained in the contract. Aggregate stop-loss coverage reimburses the plan when total eligible claims exceed a predetermined aggregate, such as 125 percent of expected claims.

Claims Incurred but Not Reported

Benefit obligations for a self-funded plan should present the amount of claims payable and currently due for active and retired participants, dependents, and beneficiaries, and claims incurred but not reported (IBNR) for active participants. IBNR for retired participants is generally included in the postretirement benefit obligation.

For a self-funded plan, the cost of IBNR should be measured at the present value, as applicable, of the estimated ultimate cost to the plan of settling the claims (including those associated with terminal diseases and catastrophic accidents) beyond the measurement date pursuant to the plan's provisions and regulatory requirements, regardless of employment status. Note that the ultimate cost to the plan may be limited to the maximum coverage specified in the plan document, stop-loss coverage, Medicare, and so on. Auditors will want to consider who calculated the IBNR estimate (calculated by sponsor, an actuary, claims administrator, and so on), the appropriateness of assumptions used, and integrity of underlying data utilized for developing the estimate. In addition, the scope of procedures performed on the IBNR estimate as part of the sponsor's financial statement audit will likely be different than that which is appropriate for the plan. So, caution should be taken when relying on audit work performed during the sponsor entity audit.

Premium Stabilization Reserves

In some fully insured or minimum premium arrangements, an insurance company may require a contract holder to maintain a premium stabilization reserve. Such reserves are usually adjusted by the insurance company at the end of the policy year. The annual adjustment is often the computed difference, or some factor thereof, between actual claims experience of the insurer and premiums paid by the contract holder. Generally, premium stabilization reserves are held in the general assets of the insurance company and are used to pay future premiums of the contract holder. If the premium stabilization reserve is certain to provide future benefits to the plan, the reserve is reported as an asset of the plan. In some cases, the contract holder may liquidate the premium stabilization reserve via cash payment from the insurance company. In other cases, the premium stabilization reserve is forfeited by the contract holder in the event of termination of coverage. Criteria for realization of the reserve are considered when evaluating the existence of the asset.

Health Savings Accounts and Health Reimbursement Arrangements

Individuals enrolled in certain high-deductible health plans (HDHPs) can establish health savings accounts (HSAs) to receive tax-favored contributions (from either the employee or employer). The contribution made to the HSA is distributed on a tax-free basis to pay or reimburse qualifying health expenses. The contribution
may be used for future expenses or may be used (on a taxable basis) for nonhealth purposes. Funds held in
the HSA can be used to pay premiums for long term care insurance and health insurance premiums while
receiving unemployment benefits or continuation benefits under COBRA. The HSA’s funds are required to
be held by an insurance company or trustee (bank). HSAs are not “use-it-or-lose-it” plans, and the participant
owns the account and is responsible for substantiating distributions from their HSA account.

A Health Reimbursement Arrangement (HRA) is similar to an HSA; however, HRAs are funded solely
through employer contributions and may not be funded by the employee through a voluntary salary
reduction agreement. No requirement exists for the arrangement to be part of an HDHP, and the funds can
be held by the employer or a VEBA trust. Employees are reimbursed tax free for qualified medical expenses
up to a maximum dollar amount for a coverage period. Although HRA amounts are not portable, unused
amounts in an HRA can generally be carried over to the next year. The employer is not permitted to refund
any part of the balance to the employee, the account cannot be used for anything other than reimbursements
for qualified medical expenses, and the plan must substantiate distributions made from the HRA account.

Should an HSA or HRA be wrapped into an audited welfare plan, consultation with the plan’s legal counsel
may be needed to determine the appropriate accounting and auditing procedures, and whether the associated
activity should be included in the audited plan’s financial statements. Possible considerations in that
determination might include where the sources of funding come from (for example, employers, participants,
or both), who has legal title to the amounts in these accounts, how the claims are adjudicated (for example,
by employer, self-adjudicated by participant, or other), whether a carry-forward provision exists into the next
plan year for unused amounts, and so on.

In Field Assistance Bulletins 2004-1 and 2006-2, the Department of Labor (DOL) addressed various questions
concerning HSAs, including the issue of whether HSAs established in connection with employment-based
group health plans constitute employee welfare benefit plans for purposes of Title I of ERISA.

**COBRA**

Many health and welfare plans are required to provide continuation of benefits upon termination of
employment through COBRA. This continuation of benefits may be considered a postemployment or
postretirement obligation, depending upon the terms of participation. In accordance with SOP 01-2, the benefit
obligation associated with COBRA would be equal to the actuarial present value of the cost of such benefits,
less the present value of expected participant contributions for such benefits. Many plans require that
participants pay the estimated full cost of health benefits provided under COBRA. In such situations, the net
cost to the plan sponsor for such benefits is zero, thus the plan would not recognize an obligation. If the plan
sponsor subsidizes the cost of health benefits under COBRA, an obligation should be recognized by the plan
to the extent that all criteria required by either Financial Accounting Standards Board (FASB) Statement No.
112, *Employers’ Accounting for Postemployment Benefits—an amendment of FASB Statements No. 5 and 43,* or FASB
Statement No. 106, *Employers’ Accounting for Postretirement Benefits Other Than Pensions,* or both, are satisfied.

In many cases, the collection of COBRA contributions and payment of COBRA benefits are performed by
TPAs. The administration of these benefits needs to be understood, so accounting for all COBRA activity is
included in the financial statements of the plan. In the event that benefits provided by COBRA are self-insured,
the obligation for IBNR claims should include COBRA participants.

Additional detailed information on COBRA continuation health coverage can be found on the DOL’s Web site

**Notices for COBRA Continuation Health Care Coverage**

The DOL has published rules clarifying the requirements for notices under COBRA for employees, employers,
and plan administrators. Under COBRA, most group health plans must give employees and their families the
opportunity to elect a temporary continuation of their group health coverage when coverage would otherwise
be lost for reasons such as termination of employment, divorce, or death. COBRA requires that certain notices
be given before individuals can elect COBRA coverage. The plan administrator must give employees and
spouses a general notice explaining COBRA when the employees and spouses first become covered under the
plan. When an event occurs that would trigger a right to elect COBRA coverage, either the employer or the
employee and his or her family members must notify the plan of the event. Finally, when the plan receives this notice, the plan must notify individuals of their COBRA rights and allow them to elect continuation coverage. Model notices contained in the regulation are available for download from the EBSA’s Web site at www.dol.gov/ebsa.

**Help Desk**—Normally COBRA allows out-of-work employees to keep their former health coverage for up to 18 months by letting them pay their share as well as the amount the employers used to pay, as well as an administrative fee. The ARRA, signed into law on February 17, 2009, includes provisions to directly provide relief to millions on the COBRA plan or ex-employees who need COBRA coverage. This “COBRA stimulus plan” will provide

- a COBRA premium subsidy. People who are currently enrolled in the COBRA plan will get a 65 percent reduction in the amount the employee pays for premium costs (that is, the employee’s out-of-pocket cost without regard to employer paid amounts). Those eligible are employees terminated between September 1, 2008, and December 31, 2009. The subsidy is limited to 9 months and is available only to those without another source of group health insurance. No premium reduction exists for periods of coverage that began prior to February 17, 2009.
- COBRA benefits to ex-employees who are denied coverage. Individuals who lost jobs after September 1, 2008, but who didn’t sign up for COBRA at the time will get a second chance to do so. Employers must send these former workers a notice by mid-April. The former employees will then have 60 days after that date to act.

For more information on COBRA Continuation Coverage Assistance under the ARRA, visit www.dol.gov/ebsa/COBRA.html.
Appendix  D—Resources for Economic Information

The Internet covers a vast amount of information that you may find valuable. Some of the sites not previously mentioned in this alert and links to relevant documents regarding economic information include those shown in the following table:

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<th>Organization/Topic</th>
<th>Web Site</th>
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<tr>
<td>Chartered Accountants of Canada Canadian Performance Reporting (CPR) Alert MD&amp;A Disclosures in Volatile and Uncertain Times</td>
<td><a href="http://www.cica.ca/download.cfm?ci_id=47101&amp;la_id=1&amp;re_id=0">www.cica.ca/download.cfm?ci_id=47101&amp;la_id=1&amp;re_id=0</a></td>
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<tr>
<td>Public Company Accounting Oversight Board (PCAOB) Staff Audit Practice Alert No. 3, Audit Considerations in the Current Economic Environment (AICPA, PCAOB Standards and Related Rules, sec. 400.03)</td>
<td><a href="http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/2008/12-05_APA_3.pdf">www.pcaobus.org/Standards/Staff_Questions_and_Answers/2008/12-05_APA_3.pdf</a></td>
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<td>PCAOB Standing Advisory Group Meeting Emerging Issue-Audit Considerations in the Current Economic Environment</td>
<td><a href="http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2008/10-22/BP_Audit_Considerations.pdf">www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2008/10-22/BP_Audit_Considerations.pdf</a></td>
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## Appendix E—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

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<td>AICPA</td>
<td>Summaries of recent auditing and other professional standards, as well as other AICPA activities</td>
<td><a href="http://www.aicpa.org">www.aicpa.org</a></td>
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<td><a href="http://www.cpa2biz.com">www.cpa2biz.com</a></td>
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<td><a href="http://www.ifrs.com">www.ifrs.com</a></td>
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<tr>
<td>AICPA Accounting and Review Services Committee</td>
<td>Summaries of review and compilation standards and interpretations</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Audit+and+Attest+Standards+Review+Services+Committee">www.aicpa.org/Professional+Resources/Accounting+and+Audit+and+Attest+Standards+Review+Services+Committee</a></td>
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<td>AICPA Professional Issues Task Force</td>
<td>Summaries of practice issues that appear to present concerns for practitioners and disseminate information or guidance, as appropriate, in the form of practice alerts</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Audit+and+Attest+Standards+Professional+Issues+Task+Force">www.aicpa.org/Professional+Resources/Accounting+and+Audit+and+Attest+Standards+Professional+Issues+Task+Force</a></td>
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<td>Economy.com</td>
<td>Source for analyses, data, forecasts, and information on the U.S. and world economies</td>
<td><a href="http://www.economy.com">www.economy.com</a></td>
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<td>The Federal Reserve Board</td>
<td>Source of key interest rates</td>
<td><a href="http://www.federalreserve.gov">www.federalreserve.gov</a></td>
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<tr>
<td>Financial Accounting Standards Board (FASB)</td>
<td>Summaries of recent accounting pronouncements and other FASB activities</td>
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<td>Government Accountability Office</td>
<td>Policy and guidance materials and reports on federal agency major rules</td>
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<td>Governmental Accounting Standards Board (GASB)</td>
<td>Summaries of recent accounting pronouncements and other GASB activities</td>
<td><a href="http://www.gasb.org">www.gasb.org</a></td>
</tr>
<tr>
<td>International Accounting Standards Board</td>
<td>Summaries of International Financial Reporting Standards and International Accounting Standards</td>
<td><a href="http://www.iasb.org">www.iasb.org</a></td>
</tr>
<tr>
<td>International Auditing and Assurance Standards Board</td>
<td>Summaries of International Standards on Auditing</td>
<td><a href="http://www.iaasb.org">www.iaasb.org</a></td>
</tr>
<tr>
<td><strong>Web Site Name</strong></td>
<td><strong>Content</strong></td>
<td><strong>Web Site</strong></td>
</tr>
<tr>
<td>-------------------------------------------------</td>
<td>-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>-------------------</td>
</tr>
<tr>
<td>International Federation of Accountants</td>
<td>Information on standards setting activities in the international arena</td>
<td><a href="http://www.ifac.org">www.ifac.org</a></td>
</tr>
<tr>
<td>Private Company Financial Reporting Committee</td>
<td>Information on the initiative to further improve FASB’s standard setting process to consider needs of private companies and their constituents of financial reporting</td>
<td><a href="http://www.pcfr.org">www.pcfr.org</a></td>
</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
<td>Information on accounting and auditing activities of the PCAOB and other matters</td>
<td><a href="http://www.pcaob.org">www.pcaob.org</a></td>
</tr>
</tbody>
</table>

[The next page is 8179.]
AAM Section 8070

State and Local Governmental Developments—2009

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of state and local governments with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also can be used by a government’s internal management to address areas of audit concern.

This publication is an other auditing publication, as defined in AU section 150, Generally Accepted Auditing Standards (AICPA, Professional Standards, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Technical Manager
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Dan O’Keefe, CPA, CFE

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your state and local governmental audits and also can be used by an entity’s internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may result in the material misstatement of financial statements and delivers information about emerging practice issues and current accounting, auditing, and regulatory developments. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.02 Further, if your state or local government audit is performed under Government Auditing Standards issued by the Comptroller General of the United States of America (also referred to as the Yellow Book or...
generally accepted government auditing standards (GAGAS) or Office of Management and Budget (OMB) Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, (referred to as a single audit) you should refer to AICPA Audit Risk Alert Government Auditing Standards and Circular A-133 Audits—2008 (product no. 022458kk). This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Audit Risk

.03 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. In AU section 312, Audit Risk and Materiality in Conducting an Audit (AICPA, Professional Standards, vol. 1), audit risk is broadly defined as the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of the risk (both inherent risk and control risk) that the relevant assertions related to balances, classes, or disclosures contain misstatements (whether caused by error or fraud) that could be material to the financial statements when aggregated with misstatements in other relevant assertions related to balances, classes, or disclosures and the risk (detection risk) that the auditor will not detect such misstatements.

.04 The auditor’s combined assessment of inherent risk and control risk is described as the risks of material misstatement. The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the risk assessment to determine the nature, timing, and extent of further audit procedures to be performed.

.05 As set forth in paragraph .12 of AU section 312, the auditor may reduce audit risk by determining overall responses and designing the nature, timing, and extent of further audit procedures. Furthermore, paragraph .19 of AU section 312 explains that the auditor should seek to reduce audit risk at the individual balance, class, or disclosure level in such a way that will enable the auditor to express an opinion on the financial statements as a whole at an appropriately low level of audit risk. In the context of a governmental audit, the overall financial statement level would be at the level of the opinion units, as discussed in paragraph 4.32 of the AICPA Audit and Accounting Guide State and Local Governments (product no. 012669kk).

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.06 AU section 314, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (AICPA, Professional Standards, vol. 1), establishes requirements and provides guidance about implementing the second standard of field work, as follows: “The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.” Obtaining this understanding is further complicated by the rapidly changing economic environment. In accordance with paragraph .04 of AU section 314, the auditor’s primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures.

.07 The auditor’s understanding of the entity and its environment consists of an understanding of the following:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
• Measurement and review of the entity’s financial performance
• Internal control, which includes the selection and application of accounting policies

.08 In addition to appendix A of AU section 314, paragraph 4.56 of AICPA Audit and Accounting Guide State and Local Governments contains examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to the categories previously discussed. Understanding the effects of the current economic climate on each specific audit client is a key step in designing the audit plan.

.09 Business risks result from conditions, events, circumstances, actions, or inactions that could adversely affect the entity’s ability to achieve its objectives and execute its strategies. The setting of inappropriate objectives and strategies also results in business risks. Just as the external environment changes, the handling of the entity’s business also is dynamic, and the entity’s strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement; however, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements; however, not all business risks give rise to risks of material misstatement.

.10 Additionally, state and local governments may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces). After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding. In the context of a governmental audit, the overall financial statement level would be at the level of the opinion units as discussed in paragraph 4.32 of the AICPA Audit and Accounting Guide State and Local Governments. Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client’s environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic and Industry Developments

The Current Economic Crisis

.11 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on an entity’s financial statements.

.12 Currently, the U.S. economy continues to experience severe instability. The National Bureau of Economic Research officially declared that, as of December 2007, the United States slid into a recession. The length of the recession and whether the United States will enter into a depression are yet to be determined. Some key occurrences that exhibit the gravity of the economic crisis include the following:

• Federal government intervention in the private sector has increased. Numerous financial institutions and automakers have received bailouts from the government.
• State governments, facing budget shortfalls in the billions of dollars, are looking to the federal government for support.
• Millions of households owe more on their mortgages than their homes are currently worth. The number of residential home foreclosures continues to increase.
• The number of jobless claims continues to increase.
• U.S. real gross domestic product (GDP), the broadest measure of economic activity, continues to decrease at an increasing rate.
The financial markets continue to experience instability—historic lows followed by rallies. In March 2009, the S&P 500 and Dow Jones Industrial Average reached their 12-year lows, and NASDAQ closed at its lowest point since October 2002.

The Federal Reserve has continued to decrease the federal funds interest rate.

The demand for U.S. Treasury bills has increased at a staggering rate, which drove the interest rate for these Treasury bills to less than 1 percent in March 2009.

The Treasuries-Over-Euro-Dollar Spread reached 4.63 percent in October 2008, a historic high, before returning to 1.04 percent in March 2009.

These key economic indicators further illustrate the severity of the recessionary period the United States is experiencing.

**Key Economic Indicators**

.14 The GDP measures output of goods and services by labor and property within the United States. It increases as the economy grows or decreases as it slows. According to preliminary estimates of the Bureau of Economic Analysis, real GDP decreased at an annual rate of 5.7 percent in the first quarter of 2009. This data indicates a continuation of the slowing of the economy seen in the fourth quarter of 2008, which experienced a decrease of 6.3 percent.

.15 The unemployment rate continues to rise steadily. In April 2009, the unemployment rate was 8.9 percent, representing approximately 13.7 million people. Since April 2008, the number of unemployed persons has increased by about 6.0 million or 3.9 percentage points.

.16 As of March 2009, the Federal Reserve had decreased the target for the federal funds rates more than 5.0 percentage points to less than 0.25 percent. The Federal Reserve noted in its March 18, 2009, press release “that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period.”

**Government Intervention to Curtail the Economic Crisis**

.17 The U.S. government has taken unprecedented actions to prevent worsening economic conditions, including passing the American Recovery and Reinvestment Act (ARRA) in February 2009 and the Emergency Economic Stabilization Act of 2008 (EESA), facilitating the sale of ailing banks and dramatically increasing the monetary programs available from the Federal Reserve. The results of these actions have not been fully realized to date.

**The American Recovery and Reinvestment Act of 2009**

.18 In February 2009, President Obama signed legislation designed to work hand in hand with the EESA to stimulate the U.S. economy. The ARRA is designed primarily to combat the rising unemployment trends, put more money in the hands of consumers, and reduce the likelihood that state and local governments will need to raise taxes significantly. According to the White House press release, the legislation will do the following:

- Create or save 3.5 million jobs in the next 2 years
- Provide direct tax relief to working and middle class families
- Double the U.S. renewable energy generating capacity over 3 years
- Stimulate private investment in renewable energy through tax credits and loan guarantees
- Invest $150 billion in U.S. infrastructure projects
- Provide funds to U.S. state and local governments to support health and education programs
Many of the provisions of this legislation took effect immediately in an effort to stimulate consumer spending and boost the economy. The total cost of the spending in the ARRA is $787 billion, which is in addition to the $700 billion in the EESA. Many economists are concerned that further financial support may be necessary before an economic recovery is possible. Additionally, the federal government developed the Web site www.recovery.gov to facilitate a transparent process to ensure accountability for the execution of the package.

To monitor these funds on behalf of the federal government, a Recovery Act Accountability and Transparency Board has been created to review management of recovery dollars and provide early warning of problems. The seven member board includes Inspectors General and federal Deputy Cabinet secretaries. The Government Accountability Office (GAO) and the Inspectors General are provided additional funds and access for reviews of the acts funds and spending. The board is responsible for coordinating and conducting oversight of federal spending under the ARRA including, but not limited to, the following:

- Ensuring that funds are awarded and distributed in a prompt, fair, and reasonable manner
- The recipients and uses of all funds are transparent to the public, and the public benefits of these funds are reported clearly, accurately, and in a timely manner
- Funds are used for authorized purposes, and instances of fraud, waste, error, and abuse are mitigated
- Projects funded under the ARRA avoid unnecessary delays and cost overruns
- Program goals are achieved, including specific program outcomes and improved results on broader economic indicators

OMB will provide a supportive role to the board.

OMB has published implementation guidance to the federal agencies on how they should carry out programs and activities enacted by the ARRA. The issuance of this guidance is happening on an as-needed basis; please check www.recovery.gov and www.whitehouse.gov/omb/recovery_default/ for current guidance. On April 3, 2009, OMB published implementation guidance for the ARRA. This is the second installment of detailed government-wide guidance for carrying out programs and activities enacted in the ARRA (Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009, M-09-15). This updated guidance supplements, amends, and clarifies the initial guidance issued by OMB on February 18, 2009 (Initial Implementing Guidance for the American Recovery and Reinvestment Act of 2009, M-09-10). Updates to the guidance are based on ongoing input received from the public, Congress, state and local government officials, grant and contract recipients, and federal personnel. The initial ARRA implementation guidance can be found at www.whitehouse.gov/omb/assets/memoranda_fy2009/m09-10.pdf, and the supplementary ARRA implementation guidance can be found at www.whitehouse.gov/omb/assets/memoranda_fy2009/m09-15.pdf. Questions and feedback about this memorandum or the guidance document can be addressed to recovery@omb.eop.gov and should have the term guidance feedback in the title of the email. OMB will issue a subsequent memorandum clarifying any updates to the guidance based on feedback received.

ARRA Compliance Requirements

For state and local governments, many new compliance requirements exist in the ARRA related to the receipt and use of funds. As required by Section 1512 of the ARRA, each recipient of federal funds under the ARRA must report the following information 10 days after each calendar quarter, beginning on July 10, 2009:

- The total amount of recovery funds received from each federal agency.
- The amount of recovery funds received that were obligated (encumbered) and expended to projects or activities. This reporting will also include unobligated federal allotment balances to facilitate reconciliations.
- A detailed list of all projects or activities for which recovery funds were obligated and expended, including the following:
— The name of the project or activity
— A description of the project or activity
— An evaluation of the project status of the project or activity
— An estimate of the number of jobs created and the number of jobs created and retained by the project or activity

• For infrastructure investments made by state and local governments, the purpose, total cost, justification for use of ARRA funds, and the name of a contact person
• Detailed information on any subcontracts or subgrants awarded by the recipient, including the data elements required to comply with the Federal Funding Accountability and Transparency Act of 2006 (P.L. 109-282), allowing aggregate reporting on awards below $25,000 or to individuals.

.24 Readers should monitor the OMB Web site, www.whitehouse.gov/omb/, for further developments. For purposes of financial statement audits of state and local governments expending ARRA funds and subject to new compliance requirements, auditors should keep in mind that AU section 317, Illegal Acts by Clients (AICPA, Professional Standards, vol. 1), requires auditors to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of misstatements arising from illegal acts that have a direct and material affect on the determination of financial statement amounts. Chapter 4 of the AICPA Audit and Accounting Guide State and Local Governments further discusses the auditor’s responsibilities under AU section 317 relating to financial statement compliance requirements. Certainly there will also be audit implications for single audits of entities expending ARRA funds. Readers should refer to the AICPA Governmental Audit Quality Center Web site, www.aicpa.org/GAQC, and the 2009 Audit Risk Alert Government Auditing Standards and Circular A-133 Audits, which is expected to be issued later this summer.

Other Government Intervention

.25 The EESA was signed into law in October 2008. As stated in Section 2 of the EESA bill, it “provide[s] authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system of the United States” to ensure the economic well-being of Americans. Primary components of the EESA bill include the following:

• An allocation of $700 billion to stabilize the U.S. financial system
• The creation of an oversight board, executive compensation rules, and other corporate governance rules for any entities that receive government aid
• An increase of the statutory limit on public debt from $10.0 trillion to $11.3 trillion
• A temporary increase of Federal Deposit Insurance Corporation insurance limits
• The creation of a tax modification for Fannie Mae and Freddie Mac stock losses
• The restatement of the Securities and Exchange Commission’s (SEC’s) authority to suspend the application of Financial Accounting Standards Board (FASB) Statement No. 157, Fair Value Measurements, which is codified at FASB Accounting Standards Codification (ASC) 820, Fair Value Measurements and Disclosures
• The requirement of the SEC to conduct a study on the impact of FASB Statement No. 157¹

.26 The EESA authorized the U.S. Treasury to create the Troubled Assets Relief Program (TARP), the original intent of which was to use $700 billion to purchase illiquid mortgage assets from banks. As part of TARP, the Capital Purchase Program (CPP) was intended to inject $250 billion of capital into banks. Half of the CPP funds were distributed to nine of the largest financial institutions in the nation, which held approximately 55 percent of U.S. banking assets. The other half of the funds were allocated for smaller

financial institutions. The clear intent of the CPP was for the participating banks to increase lending; however, many question if the banks have responded accordingly.

.27 In addition to bailout funds targeting financial institutions, a $17.4 billion rescue package for the U.S. automakers was issued in December 2008. The first $13.4 billion was lent to the automakers immediately, and the remaining $4 billion was lent in subsequent months. The U.S. government will continue to work directly with automakers and also will receive nonvoting warrants from automakers that accept taxpayer funding.

.28 The complete effects of the ARRA, as well as the other government interventions, will take time to be felt throughout the economy; however, the primary goal is to increase market confidence and liquidity.

The State of the States’ Economy

.29 The Nelson A. Rockefeller Institute of Government (institute) publishes frequent updates on state fiscal conditions. The institute’s State Revenue Report, dated April 2009, focuses on concerns over a recessionary economy and the likely impact on state government finances and includes the following highlights based on U.S. Census Bureau data:

- State tax revenues for the fourth quarter of 2008, after adjusting for inflation, legislative changes, and known anomalies, declined in 41 states.

- In the final quarter of 2008, total state revenues showed a decline at an overall rate of 4 percent, representing declines in sales tax revenues of 6.1 percent and income tax revenues of 1.1 percent.

- A rise in local property tax collections of 4.6 percent in fourth quarter 2008 was offset by a decrease in sales tax revenues, posting an overall 3.2 percent increase.

- The decline in state revenues is continuing in 2009 with preliminary figures showing a 12 percent decrease as weakening conditions in the economy are reflected in major losses for sales and income taxes relative to a year earlier.

- States can expect personal income tax collections in April to show substantial decreases as a result of the economic downturn in 2008.

.30 The report concludes by pointing out that the overall economy has continued to decline and tax revenues, which lag behind the trend of the economy, will likely follow suit. The full text of this report can be found at www.rockinst.org/pdf/government_finance/state_revenue_report/2009-04-14-(75)-state_revenue_report_sales_tax_decline.pdf.

Local Government Bankruptcies

.31 As a result of declining property tax revenues, contractual salary increases, and unfunded pension obligations, in May 2008, the City of Vallejo, California filed for bankruptcy protection under Chapter 9, Adjustment of Debts of a Municipality, of title 11 of the United States Code (see the discussion of the Government Accounting Standards Board [GASB] project on Chapter 9 in the “On the Horizon” section of this alert). The city determined that after large current and larger projected budget deficits, it would be unable to honor existing union contracts and debt obligations to city employees. The city has asked the court to modify the terms of these agreements.

.32 The purpose of Chapter 9 is to provide a financially-distressed municipality protection from its creditors while it develops and negotiates a plan for adjusting its debts. Reorganization of the debts of a municipality is typically accomplished either by extending debt maturities, reducing the amount of principal or interest, or refinancing the debt by obtaining a new loan. Although similar to other chapters, in some respects, Chapter 9 is significantly different in that there is no provision in the law for liquidation of the assets of the municipality and distribution of the proceeds to creditors.

.33 Only a “municipality” may file for relief under Chapter 9. The term municipality is defined in title 11 of the U.S. Code as a “political subdivision or public agency or instrumentality of a State.” The definition is
broad enough to include cities, counties, townships, school districts, and public improvement districts. It also includes revenue-producing bodies that provide services which are paid for by users rather than by general taxes, such as bridge authorities, highway authorities, and gas authorities. States are not eligible to file under Chapter 9. Also, some states restrict or prohibit bankruptcy filings by municipalities.

.34 Municipal bankruptcy filings are a rare occurrence when compared to other types of bankruptcies. Of more than 55,000 municipal entities, less than 600 have filed under Chapter 9 since 1937. By comparison, in 2008, there were 744,424 filings under Chapter 7 and 10,160 filings under Chapter 11, of which 30,035 and 9,272, respectively, were business filings.

.35 If the City of Vallejo is successful in restructuring its contracts with the unions representing public employees and the court permits its debt obligations to be restructured, there will be a variety of results. The short-term impact is that the city will be relieved of its unfunded obligations for pensions and other postemployment benefits (OPEB) and significantly reduce future payroll related expenses. The long-term impact may be that the city finds itself unable to fill employment vacancies or to borrow money for future capital projects such as building bridges, roads, sewers, or other large scale public projects.

.36 The outcome of this case will be of special interest to other municipalities struggling with huge unfunded pension and OPEB obligations and shrinking revenues and their auditors. See the “Accounting Issues and Developments” section of this alert for a discussion of GASB Statement No. 56, Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards, which includes additional going concern considerations and requirements for governments.

Municipal Securities and Challenges in the Municipal Market

.37 In 2008, nearly $453 billion of municipal bonds and notes were sold to support a variety of public purposes. Additionally, over 10 million municipal trades occurred representing over $5.5 trillion in transactions during 2008. With approximately $2.7 trillion in principal value of securities outstanding and over 50,000 issuers, the municipal market continues to play a vital role in the U.S. economy.

.38 Beginning in late 2007 and throughout 2008, the municipal market experienced several dislocations related to the subprime mortgage crisis and associated turmoil in the credit markets. These included the downgrading of municipal bond insurers and the collapse of the municipal auction rate securities market.

.39 For many years, the credit enhancement provided by AAA-rated bond insurers was a prominent feature of the municipal securities market. As of the beginning of 2008, approximately 50 percent of all long-term municipal bonds were insured. However, credit rating agencies extensively downgraded bond insurers during 2008, primarily as a result of their exposure to subprime mortgage products. Hundreds of thousands of outstanding insured municipal bonds were affected by these downgrades. Use of bond insurance on new issues—something that, in previous years, had been used to help sell about half of all new issues—was used on only 18 percent of new issues during 2008.

.40 Another exceptional event during 2008 was the collapse in the $200 billion market for municipal auction rate securities (ARS). Prior to 2008, municipal auctions for these securities rarely failed. As the subprime mortgage crisis took hold and concerns over the credit quality of the bond insurance used on most ARS increased, auctions began to fail early in the year. Investor confidence in the auction process waned, which in turn, led to more auction failures and the collapse of the ARS market. All but about $78 billion in municipal ARS has now been restructured. However, for those ARS remaining outstanding, most auctions continue to fail, making the securities essentially illiquid.

.41 General conditions in the municipal securities market have improved since the most extreme dislocations and liquidity shortages that occurred in the last quarter of 2008. Attracted by the higher yields, retail demand (particularly for high-grade credits) has been strong and has compensated for the loss of demand by many traditional institutional and leveraged accounts. Notwithstanding this general improvement, imbalances in supply and demand and illiquidity problems remain in certain segments areas of the market as of
the early months of 2009. This is particularly true for lower rated issues and securities in certain market sectors such as housing.

The Credit Crisis and Its Potential Impact on Local Government Credit Ratings

.42 Local governments were put on notice in a recent report, Impact of the Credit Crisis and Recession on Local Governments, from the U.S. Public Finance division of Moody’s Investors Service. The credit experts at Moody’s believe that with the U.S. economic recession intensifying, and the continuing credit crisis limiting access to the credit markets, many local governments will face difficult fiscal choices, and some potentially may experience material stress over the next few years. The downturn in real estate values has heightened the general economy’s impact on municipal governments’ budgets, especially in local governments with a heavy reliance on property tax revenues. Moody’s concludes that with the recession now appearing to have spread to most regions and sectors of the economy, few local governments will escape the difficult choice between raising taxes in the face of local economic stress and cutting services to balance their budgets. However, Moody’s expects that the majority of municipalities will manage successfully through this period with a combination of spending cuts and revenue enhancement plans.

.43 The report concludes that although most municipalities have a reasonable degree of fiscal flexibility and demonstrated an ability to adapt to economic and fiscal cycles in the past, this recession is likely to be deeper and longer lasting than recent ones. As a result, Moody’s said it expects that there will be a higher number of negative rating actions taken than in other recessions of the past 40 years, as some issuers experience disproportionate levels of stress that materially affect creditworthiness. The credit rating agency has said that its ratings actions will focus on municipal governments that experience higher levels of financial stress than comparably rated peers, and that additional downward rating pressure could result if this economic downturn proves exceedingly deep.

.44 Local governments with strong management teams, diverse revenue sources, predictable borrowing costs, and sound liquidity and reserves are expected to fare better than those without these characteristics and conditions. According to Moody’s, generally speaking, the local government leadership’s willingness to make necessary adjustments will be a key factor in maintaining that government’s credit rating. For example, a municipality’s failure to adjust its budget in a timely fashion could be considered a clear indicator of weak fiscal management and could place significant downward pressure on its credit rating.

.45 Auditors should consider whether a risk exists that the government’s credit rating could be lowered and, if so, obtain an understanding of the effects that a reduced credit rating would have on the government’s ability to fund its operations, or if a reduced rating would affect the government’s outstanding debt obligations.

Tax Exempt Debt Issues

.46 The current credit environment has affected the market for debt securities. Although all debt securities may be affected, particular issues affect municipalities, states, cities, and other governments (such as redevelopment agencies, school districts, public universities, airports, and seaports) issuing tax exempt debt. Some examples of these tax exempt debt securities are ARSs and variable rate demand obligations (VRDOs).

.47 Although each situation is different and should be evaluated based on its own specific facts and circumstances, the current situation may raise various accounting and auditing issues pertaining to tax exempt debt including, but not limited to, the following:

- Bond restructurings
- Derivative and hedge accounting implications
- Potential violation of debt covenants
- Classification of the debt on the balance sheet as either a current or noncurrent liability
- Subsequent event disclosures
- Going concern issues
For further information, refer to a nonauthoritative article that the AICPA has posted to its Web site, authored by an ad hoc group of AICPA members, *Tax-Exempt Bonds—Accounting and Auditing Considerations in the Current Environment*. The article can be accessed at www.aicpa.org/download/acctstd/ARS_article14.pdf.

**Postemployment Benefits Other Than Pensions, Including Retiree Health Care**

Costs for postemployment benefits other than pensions, including retiree health care, continue to be an economic issue of major concern for most state and local governments. In its report, *Promises with a Price*, the Pew Charitable Trusts conservatively estimated that state governments will spend approximately $2.73 trillion on pensions, health care, and other postemployment benefits during the next 30 years, of which $381 billion is the price tag for retiree health care and other nonpension benefits. The report cites 8 states whose unfunded actuarial liability for OPEB is greater than its unfunded actuarial liability for its pension plans. The reports indicate that in the state of California alone, annual state and local government retiree health care costs were $4 billion in 2006 and are expected to escalate to $10 billion in 2012 and $27 billion in 2019. With people living longer, the rising cost of health care, and few governments funding these costs as incurred through irrevocable trusts, the unfunded liabilities are likely to grow at an ever-increasing pace. The Pew report is available at www.pewcenteronthestates.org/uploadedfiles/Promises%20with%20a%20Price.pdf.

As the required implementation dates for GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, have arrived for some and are approaching for others, the focus on OPEB, including retiree health benefits for state and local government employees has been increasing. Because many governments previously have not measured or disclosed in their financial statements their obligations to pay OPEB costs, the media, the bond market, and state and local government legislative bodies are starting to focus on the potentially significant sum of those obligations, sometimes in the billions of dollars for an individual state. In addition, a government that does not manage its OPEB liability on a go-forward basis, especially the growth in its liability, could find itself explaining its OPEB and funding policies or lack of a funding policy to credit rating agencies when issuing bonded debt.

Public employee unions and retirement benefit administrators across the country are concerned that a change from the pay-as-you-go accounting approach might lead to a reduction in benefits. Many predict significant changes in OPEB as governing bodies become better informed through actuarial or similar valuations about the amount of the obligations and the effects of not managing them. Some governments have formed task forces to help them identify solutions. Auditors might consider working with the actuarial firms retained by the auditee or, if necessary, retaining actuarial specialists to evaluate auditee valuations; at the same time, auditors might also consider preparing themselves to answer their auditees’ questions about managing those obligations.

Common solutions that have been discussed for managing the OPEB obligation and its growth include restricting new entrants into the plan, raising the employee cost share, lengthening the vesting period, restricting ad hoc benefit increases, and converting a defined benefit plan to a defined contribution plan. Another common solution is to begin to advance-fund the obligation as normally is done with pension obligations, which is a long-term solution that will take years with a well-managed funding program to fully fund the accrued liability. Some governments may even consider discontinuing or reducing benefits for current and retired employees, although that may not be possible because of legal, contractual, or other restraints. Whichever solutions are chosen by the entity, they likely will be difficult to implement.

A recent study and report by the GAO looked into both the current status of state and local government retiree benefit structures and the fiscal outlook for funding their future costs. The report noted that a heightened sense of concern has been raised questioning whether state and local governments offering such benefits will be able to continue to provide the current level of benefits to retirees in the future.

State and local government employees make up approximately 12 percent of the nation’s workforce and are generally provided retiree benefits in two components: pensions and retiree health care. The GAO
report found that significant differences existed between how these two benefit components were structured, managed, and funded.

### Differences Between Pension and Retiree Health Care Systems

<table>
<thead>
<tr>
<th></th>
<th>Pensions</th>
<th>Retiree Health Care</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>How Structured</strong></td>
<td>Mostly as a defined benefit based on a formula; once accrued, cannot be diminished</td>
<td>Varied sharing of premium costs between the government and retiree; benefit plans can change for current and future retirees</td>
</tr>
<tr>
<td><strong>How Managed</strong></td>
<td>As trusts, with board of trustees oversight</td>
<td>As operating expenses managed with other employee benefits</td>
</tr>
<tr>
<td><strong>How Funded</strong></td>
<td>Prefunded, with monies set aside and invested</td>
<td>Pay-as-you-go funded, with annual operating funds used as costs are required to be paid</td>
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.55 The GAO study results simulated the outlook for the state and local government sector as a whole and concluded that

1. estimated future pension costs (currently about 9 percent of employee pay) would require an increase in annual government contribution rates of less than 0.5 percent; and

2. estimated future retiree health care costs (currently about 2 percent of employee pay) would more than double by the year 2050 if they continue to be funded on a pay-as-you-go basis.

.56 The GAO did recognize the sensitivity of its estimates to assumed rates of return and projected inflation rates; however, it also recognized that if rates of return were to fall below historical averages, the funding requirement could become even higher. The GAO report concluded that although state and local governments have strategies to manage future pension costs, similar strategies were not in place to manage the escalating costs of retiree health care. The GAO suggested that in future debates on retiree benefits, policy makers, voters, and beneficiaries will need to decide how to control costs, the appropriate level of benefits, and who should pay the costs.

.57 The entire GAO report is available from the GAO Web site as report no. GAO-07-1156 at www.gao.gov.

### Securities Lending Losses

.58 Many governments have invested the collateral received under a securities lending agreement. The values of many of these investments have been affected by the general downturn of the economy. These governments may have lost enough market value on the collateral so that they may be unable to terminate the security lending liability without using the government’s own cash and investments.

.59 The economy has highlighted a common misunderstanding in applying generally accepted accounting principles (GAAP) to securities lending transactions. Most entities understand the concepts of when and how to record the transactions. However, many entities have not booked the adjustments to value the collateral at fair market value.

.60 Accounting for securities lending transactions is outlined in GASB Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions*. This standard addresses the accounting and disclosures for securities lent to the broker, the collateral received from the broker, and costs related to these types of transactions.
The securities lent to the broker should be recorded as an asset on the statement of net assets. The government frequently retains ownership of the original securities lent to the broker. These securities will be returned at the termination of the agreement. The government would value these securities using the guidance outlined in GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investment and for External Investment Pools*. This statement generally requires reporting investments at fair value.

The collateral received from the broker requires careful analysis to understand which party is bearing the risk of loss on the collateral. Risk of loss on the collateral is characterized in GASB Statement No. 28 by analyzing the following government’s factors:

- The ability to pledge (that is, promise) the collateral to others without the broker’s default
- The ability to sell the collateral without the broker’s default

Stated more plainly, unless the broker agrees to maintain the risk of loss on the collateral, the government has the risk of loss. The following factors could indicate that the broker has retained the risk of loss:

- An explicit statement in the agreement
- The government’s inability to change the nature of the collateral (that is, sell securities for cash, buy securities with the cash)
- If the collateral lost 100 percent of its value, the government would not be liable to pay back the collateral

Under GASB Statement No. 28, collateral is not recorded as an asset on the government’s statement of net assets if the broker maintains the risk of loss. In addition, the corresponding liability would not exist. If the government has assumed the risk of loss, the government would originally record an asset at fair value upon receipt of collateral and a liability for the amount owed to the broker at the termination of the agreement. The asset booked may be uninvested cash collateral or investments received as collateral or purchased with cash collateral. Investment should be measured according to GASB Statement No. 31, generally measured at fair value. Fair value changes should be reported in investment income. The amount of the corresponding liability (the obligation to return the collateral) would remain the amount due to the broker at termination of the agreement.

It is important for governments participating in external and internal investment pools and their auditors to gain a thorough understanding of the valuation methodology that these pools apply to its investments, the underlying risks involved with each investment type, and the likelihood that the value of the investments will be impaired.

**Electronic Commerce and Privacy of Data Concerns**

In September 2006 American Express, Discover Financial Services, JCB, MasterCard Worldwide, and Visa International jointly announced the formation of the PCI Security Standards Council, which is designed to manage the ongoing evolution of the Payment Card Industry (PCI) Data Security Standard (DSS). PCI DSS focuses on improving payment account security throughout the transaction process with the goal of enhancing protection against data theft and fraud.

The PCI DSS is a multifaceted security standard that includes requirements for security management, policies, procedures, network architecture, software design, and other critical protective measures. This comprehensive standard is intended to help organizations proactively protect customer account data. The core of the PCI DSS is a group of principles and accompanying requirements, around which the specific elements of the DSS are organized:

- Build and maintain a secure network
  - Requirement 1: Install and maintain a firewall configuration to protect cardholder data
- Requirement 2: Do not use vendor-supplied defaults for system passwords and other security parameters

- Protect cardholder data
  - Requirement 3: Protect stored cardholder data
  - Requirement 4: Encrypt transmission of cardholder data across open, public networks

- Maintain a vulnerability management program
  - Requirement 5: Use and regularly update anti-virus software
  - Requirement 6: Develop and maintain secure systems and applications

- Implement strong access control measures
  - Requirement 7: Restrict access to cardholder data by business need-to-know
  - Requirement 8: Assign a unique ID to each person with computer access
  - Requirement 9: Restrict physical access to cardholder data

- Regularly monitor and test networks
  - Requirement 10: Track and monitor all access to network resources and cardholder data
  - Requirement 11: Regularly test security systems and processes

- Maintain an information security policy
  - Requirement 12: Maintain a policy that addresses information security

These requirements extend beyond credit card processing to organizational data security and privacy controls. Qualified security assessors (QSAs) and approved scanning vendors (ASVs) are companies regulated by the PCI Security Standards Council, which monitor and assist governments and merchants with PCI DSS implementation. The volume of transactions processed determines the frequency of the required QSA and ASV certification. Compliance must be updated at least annually, and testing needs to occur at least quarterly or with any major system change.

When PCI DSS is fully implemented by the credit card brands, lack of a PCI certification would prevent the government from collecting revenues electronically. At this point, there is no fixed timetable for governments to initially comply with PCI DSS. The timeframe for compliance varies by the payment card brands (for example, American Express). Many of the brands have already implemented deadlines for compliance, but each payment card brand may have a different deadline. Additional information about PCI DSS can be found at www.pcisecuritystandards.org.

Legislative and Regulatory Developments

Municipal Securities Rulemaking Board Activity

The Municipal Securities Rulemaking Board (MSRB), which develops rules for brokers, dealers, and banks engaged in underwriting, trading, and selling municipal securities, protects investors and ensures the integrity of the municipal market. The MSRB also operates information systems designed to promote transaction price transparency and access to municipal securities issuer disclosure documents.

Electronic Municipal Market Access

One of the MSRB’s top initiatives over the last year has been the development of its Electronic Municipal Market Access (EMMA) Web site, which provides improved disclosure and price transparency in the municipal market. Official statements and advance refunding documents for municipal bonds, real-time and historical trade data, interest rates and auction results for municipal auction rate securities, interest rates...
for variable rate demand obligations, daily market statistics, and educational material about municipal bonds are all available for free on EMMA (www.emma.msrb.org). The EMMA Web site is designed for use by individual investors but is also available to auditors, institutional investors, and municipal issuers so that any user easily can obtain free municipal securities disclosure documents from a single source.

.72 The data on the EMMA Web site comes from a number of sources. The MSRB collects primary market information and trade data for EMMA from underwriters and their agents. Beginning July 1, 2009, the MSRB will collect continuing disclosure documents from municipal issuers around the country and post them for public availability within 15 minutes of receipt. The addition of these documents, and their availability to the public through EMMA, will create a complete repository of municipal bond disclosure documentation in a single location that is free and accessible 24-hours a day.

Continuing Disclosure

.73 Another phase of EMMA’s development incorporates continuing disclosure documents provided by issuers into the integrated document display on EMMA. In December 2008 the SEC approved a proposal from the MSRB, which amends SEC Rule 15c2-12 (Title 17 CFR 240.15c2-12) to allow the expansion of EMMA to include these documents and to make the MSRB the central and only filing venue for these documents, replacing existing document depositories (that is, Nationally Recognized Municipal Securities Information Repositories and State Information Depositories). The change, effective July 1, 2009, has broad industry support because EMMA will provide a far more efficient and cost-effective system of document collection and dissemination. The MSRB is currently creating the necessary framework for issuers and their agents to submit continuing disclosure documents to EMMA in an all-electronic format and working to educate them about the process. Further information is available at www.msrb.org. Also, see chapter 16 of the AICPA Audit and Accounting Guide State and Local Governments for additional information about auditor association with municipal securities filings.

Other EMMA Features

.74 EMMA contains an extensive education center that provides in-depth information to help investors learn about the municipal bond market and better understand disclosure and trade price information provided through EMMA. Investors of all types, from beginners to those with advanced knowledge, can find useful information in the education center and through EMMA’s Frequently Asked Questions (FAQ) section. The education center also includes the MSRB’s industry-standard glossary of municipal securities terms.

Short-Term Obligation Rate Transparency System

.75 In 2009, the MSRB implemented its Short-Term Obligation Rate Transparency (SHORT) system to increase transparency of municipal ARS and VRDOs. The SHORT system is the first centralized system for collection and dissemination of critical market information about ARS and VRDO. Information collected by the SHORT system is made available to the public, free of charge, on the MSRB’s EMMA Web site.

.76 The SHORT system will be implemented in phases. The first phase collects and disseminates interest rate and descriptive information about ARS and VRDO. On January 30, 2009, the SHORT system became operational for ARS and, on April 1, 2009, for VRDO. This “interest rate information” allows market participants to compare ARS and VRDO across issues and track current interest rates. Included in this information is the current interest rate, the length of the interest rate reset period, as well as characteristics of the security such as the identities of broker-dealers associated with the operation of the securities. This system is a useful tool for both auditors and their clients to evaluate, assess, and value relevant securities.

.77 Later phases of this initiative to increase transparency of ARS and VRDO include the collection and dissemination of ARS bidding information. This information will allow market participants to obtain important information about the liquidity of an ARS and greater granularity into the results of the auction process. In addition, the MSRB plans to collect ARS documents that describe auction procedures and interest rate setting mechanisms as well as VRDO documents that describe the provisions of liquidity facilities, such
as letters of credit and standby bond purchase agreements. More information about the SHORT system is available at www.msrb.org/msrb1/whatsnew/2008-49.asp.

**Bank Tying**

.78 On August 14, 2008, the MSRB issued Notice 2008-34, Notice on Bank Tying Arrangements, Underpricing of Credit and Rule G-17 on Fair Dealing. In 2008, there was a major increase in demand for bank letters of credit and bank liquidity facilities by state and local government issuers of VRDOs. Some issuers of outstanding VRDOs were seeking to substitute letters of credit for bond insurance provided by downgraded monoline insurers. Other issuers were seeking to issue VRDOs to refund auction rate securities after auctions began to fail. The MSRB was concerned that, as a result of this increase in demand for letters of credit and liquidity facilities (bank facilities), some banks might consider proposing to issuers that they would receive a bank facility if their securities affiliates were selected as underwriters or remarketing agents for the issuer’s VRDOs. There was also concern that banks might offer to price bank facilities on below market terms in return for underwriting or remarketing business for their securities affiliates. Notice 2008-34 reminded bank-affiliated dealers that there are federal prohibitions on such tying or underpricing arrangements, and that a dealer who aids or abets such arrangements would also violate MSRB Rule G-17, Conduct of Municipal Securities Activities. The full text of the notice is available at www.msrb.org/msrb1/archive/2008/2008-34.asp.

**Restrictions Related to Political Contributions**

.79 MSRB Rule G-37, Political Contributions and Prohibitions on Municipal Securities Business, prohibits any dealer from engaging in municipal securities business with an issuer within two years after any contribution to an official of such issuer is made by (1) the dealer; (2) any municipal finance professional associated with such dealer; or (3) any political action committee controlled by the dealer or any municipal finance professional. If a municipal finance professional makes a political contribution to an issuer official for whom he is not entitled to vote, the dealer is prohibited from engaging in municipal securities business with that issuer for two years.

.80 The only exception to Rule G-37’s absolute prohibition on municipal securities business is for certain contributions made to issuer officials by municipal finance professionals. Contributions by such persons to officials of issuers do not invoke application of the prohibition on business if (1) the municipal finance professional is entitled to vote for such official, and (2) contributions by such municipal finance professional do not exceed, in total, $250 to each official, per election.

.81 Recently, the MSRB has undertaken a full review of Rule G-37, including whether or not Rule G-37 should include certain prohibitions on or require certain disclosures of bond ballot campaign contributions. The full text of Rule G-37 can be found at www.msrb.org/msrb1/rules/ruleg37.htm.

**New IRS Regulation on Required Withholding**

.82 IRS Proposed Regulations REG-158747-06 were published in the Federal Register on December 5, 2008 for new IRC subsection 3402(t). This subsection, created by the Tax Increase Prevention and Reconciliation Act of 2005, originally required that payments by governmental entities for goods or services after December 31, 2010, are subject to 3 percent income tax withholding, with some exceptions. The implementation date has now been changed by the ARRA and applied to payments after December 31, 2011. Although this proposed regulation will not affect audits in 2009, auditors may want to bring the issue to the attention of their clients.

.83 These new withholding requirements would apply to payments greater than $10,000 made by

- the entire U.S. government, including all federal agencies, the executive branch, the legislative branch, and the judicial branch.
- all states, including the District of Columbia (but not including Indian tribal governments).
- all political subdivisions of a state government or every instrumentality of such subdivisions unless the instrumentality makes annual payments for property or services of less than $100 million.
Generally, withholding would be required on all payments to all persons providing property or services to the government, including individuals, trusts, estates, partnerships, associations, and corporations. Withholding would occur at the time of payment and applies to payment in any form (cash, check, credit card, or payment card). If the government entity fails to withhold the tax required under Section 3402(t), it becomes liable for the payment of the tax.

The proposed regulations provide the following exceptions from the withholding requirements:

- Payments otherwise subject to withholding, such as wages.
- Payments for retirement benefits, unemployment compensation, or social security.
- Payments subject to backup withholding, if the required backup withholding is actually performed.
- Payments for real property.
- Payment of interest.
- Payments to other government entities, foreign governments, tax exempt organizations, or Indian tribes.
- Payments made under confidential or classified contracts, as described in IRC 6050M(e)(3).
- Payments made by a political subdivision of a state or instrumentalities of a political subdivision of a state that make annual payments for property of services of less than $100 million.
- Public assistance payments made on the basis of need or income. However, assistance programs based solely on age, such as Medicare, are subject to the requirements.
- Payments to employees in connection with service, such as retirement plan contributions, fringe benefits, and expense reimbursements under an accountable plan.
- Payments received by nonresident aliens and foreign corporations.
- Payments made by Indian tribal governments.
- Payments in emergency or disaster situations.

For more details, please see the proposed regulations, which can be accessed at www.regulations.gov/fdmspublic/component/main?main=DocumentDetail&o=09000064807ce036.

“Red Flags” Rule

In October 2007 the Federal Trade Commission (FTC) issued the “Red Flags” rule for financial institutions and creditors to fight identity theft. The rule sets out how certain businesses and organizations must develop, implement, and administer their identity theft prevention programs. These programs must include the following four basic elements, which together, create a framework to address the threat of identity theft.

1. The program must include reasonable policies and procedures to identify the “red flags” of identity theft that may arise in the day-to-day operation of your business. Red flags are suspicious patterns or practices or specific activities that indicate the possibility of identity theft. For example, if a customer has to provide some form of identification to open an account with an entity, an ID that looks like it might be fictitious would be a “red flag.”

2. The program must be designed to detect the red flags that have been identified. For example, if an entity has identified fake IDs as a red flag, it must have procedures in place to detect possible fake, forged, or altered identification.

3. The program must spell out appropriate actions to take when red flags are detected.

4. The program must address how the program will be reevaluated periodically to reflect new risks from this crime because identity theft is an ever-changing threat.
The program must state who is responsible for implementing and administering it effectively. Because employees have a role to play in preventing and detecting identity theft, the program also must include appropriate staff training. The program also must address the manner in which contractors will be monitored when outsourcing or subcontracting functions of operations that would be covered by the rule.

The Red Flags rule applies to financial institutions and creditors. The rule requires a periodic risk assessment to determine if the entity has covered accounts. A written program needs to be in place only if the entity has covered accounts. It is important to look closely at how the rule defines financial institution and creditor because the terms apply to groups that typically might not use those words to describe themselves. For example, many not-for-profit entities and government agencies are creditors under the rule.

Governments need to implement the Red Flags rule if they defer payment for goods or services. An example would be payment plans for taxes due or student loans for public institutions of higher education. Because of their creditor status in these situations, the Red Flags rule applies.

The FTC suspended enforcement of the new Red Flags rule until May 1, 2009, to give creditors and financial institutions additional time in which to develop and implement written identity theft prevention programs. This deferral by the FTC does not affect other federal agencies’ enforcement of the original November 1, 2008, deadline for institutions subject to their oversight to be in compliance.

More information and a document outlining specific requirements of the Red Flags rule can be found at http://ftc.gov/redflagsrule.

New Guidance Issued on Public Housing Agencies Completion of the Financial Data Schedule and Related Auditor Reporting

In December 2008, the U.S. Department of Housing and Urban Development (HUD) issued guidance titled, Revised SAS 29 Audited Submission Procedure for Public Housing Agencies (PHAs) With Fiscal Year End of June 30, 2008. That guidance explained how PHAs could meet the requirements for preparing the required financial data schedule (FDS), as well as the related auditor reporting, in light of delays in the availability of a revised FDS format.

Since then, HUD has issued another notice to PHAs on its Web site, Un-Audited Financial Submission Procedure for Public Housing Agencies With Fiscal Year Ends of June 30, 2008 Through March 31, 2009, announcing the availability of the previously promised Excel tool version of the updated FDS (the FDS tool) and instructions for submitting it. This guidance contains information for auditors who are issuing the “in relation to” reporting (that is, a SAS 29 opinion) on the FDS.

The new HUD notice instructs PHAs on how to complete and submit electronically the new FDS tool. It also provides an FDS user manual, a full accrual version of the tool, a modified accrual version of the tool, and an FAQ document. In summary, the PHA submission process of the FDS tool will work as follows:

- The PHA will complete the appropriate FDS tool (that is, either accrual or modified accrual); and
- The PHA will make the “unaudited” submission of the FDS tool to HUD using the Comments link contained in the Financial Assessment Subsystem (FASS) online system.

PHAs with fiscal years ending June 30, September 30, or December 31, 2008, had until April 13, 2009 to complete this submission. PHAs with fiscal year ending March 31, 2009, will have until June 30, 2009 to complete their submissions.

HUD considers this submission “unaudited” in that it does not include the upload of the audited financial statements and other required materials or the required agreed-upon procedures engagement comparing the hard copy FDS to the electronic FASS submission. Currently, HUD is continuing to update the FASS to, among other things, add audit system functionality. Once the system update is completed, HUD will communicate how PHAs can make their “audited” submission. At that time, the system will allow for the
required agreed-upon procedures engagement and will include the six tabs for uploading the management’s
discussion and analysis, the financial statements, notes to the financial statements, audit reports, audit
findings, and the corrective action plan. HUD will post another notice to its Web site notifying PHAs when
the next phase is complete and the audited submission can occur.

The Status of the In-Relation-To Reporting Requirement

.98 HUD states in its FAQ document that even though the final “audited” submission to HUD will not be
able to be made by PHAs for several more months, PHAs can use the newly released FDS tool for purposes
of having their auditors issue the required SAS 29 opinion. Accordingly, HUD states that PHAs may print the
completed “unaudited” FDS tool, and the PHA auditor can perform the necessary audit procedures in order
to issue the SAS 29 opinion on the FDS.

Auditor Subsequent Event Considerations

.99 Now that HUD has released the FDS tool, PHAs will likely begin asking their auditors to complete the
necessary procedures in order to issue the SAS 29 opinion on the FDS. Auditors should keep in mind their
potential subsequent event responsibilities under AU section 560, Subsequent Events (AICPA, Professional
Standards, vol. 1), relating to each of the two options that HUD provided for meeting the preparation and
reporting requirements for the FDS. In both cases, the auditor performs the subsequent audit procedures to
ascertain whether there have been any subsequent events that may require adjustment or disclosure to a fair
presentation of the financial statements. Paragraphs .10–.12 of AU section 560 discuss auditing procedures in
a subsequent period in more detail.

.100 More information about the notice and an illustrative report for a SAS 29 opinion are available at the
AICPA Government Audit Quality Center Web site at http://gaqc.aicpa.org/Resources/Archived+GAQC+
Update+Newsletters/GAQC+Alert+No.+104.htm.

Sales Tax on Internet Sales

.101 For years, this alert has discussed the ongoing debate about the taxation of Internet sales. As discussed
in the prior alerts, the Internet Tax Nondiscrimination Act (Public Law [P.L.] 108-357, December 3, 2004) bans
new Internet access taxes and new, multiple, and discriminatory taxes on electronic commerce (e-commerce;
that is, Internet sales) until November 1, 2007. On October 31, 2007, President Bush signed a bill that provided
an extension of the moratorium for another seven years. P.L. 110-108, the Internet Tax Freedom Act Amend-
ments Act of 2007, extended the moratorium to November 1, 2014, makes some changes to the grandfather
clause in the original legislation that protects state and local taxes imposed on Internet access prior to 1998,
and clarifies the definition of Internet access. Some legislators support a permanent ban and, in January 2007,
introduced a resolution, Permanent Internet Tax Freedom Act (H.R. 743).

.102 However, New York State has enacted a law to collect sales taxes on Internet sales from any retailer
that advertises on New York-based Web sites. The law, which became effective on June 1, 2008, equates New
York-based Web sites with having a physical presence in the state. The law applies to companies that don’t
have offices in New York, but have at least one person in the state who works as an online agent, that is,
someone who links to a Web site and receives commissions from sales. Internet retailers sued the State of New
York, arguing that the tax is unconstitutional. The initial rounds of legal action have found in favor of the state,
with the courts saying that the suits had no basis for legal action.

.103 Several states, including Maryland, California, and Hawaii are considering legislation modeled on the
New York law.
Audit and Attestation Issues and Developments

Audit Risks Arising From Current Economic Conditions

.104 The recent economic conditions and regulatory actions described in this alert may cause additional risk factors that had not previously existed or did not have a material effect on audit clients in prior years. Some risks that may affect a government in the current economic environment are as follows:

- Constraints on the availability of capital and credit
- Going concern and liquidity issues
- Marginally achieving explicitly stated budget and strategic objectives
- Special purpose entities, joint ventures, or other complex financing arrangements
- Volatile real estate and business markets
- The credit crisis, which can cause significant measurement uncertainty, including accounting estimates and fair value measurements

.105 Although many of these risks are not new to governments, consideration of the ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks. As noted in paragraph .17 of AU section 312, some possible audit responses to a significant risk of material misstatement include increasing the extent of audit procedures, performing procedures closer to year-end, or increasing audit procedures to obtain more persuasive evidence. Additionally, given the constantly changing status of economic conditions that could affect your client, auditors should consider modifying audit procedures to ensure that risks are still adequately addressed.

.106 Although it is impossible to predict and include all accounting, auditing, and attestation issues that may affect your engagements, in this alert, we cover the primary areas of concern given the current economic conditions. Continue to remain alert to economic, legislative, and regulatory developments, as well as the associated accounting, auditing, and attestation issues as you perform your engagements.

Structured Investment Vehicles

.107 Many state and local governments have found themselves invested in structured investment vehicles (SIVs) without a sufficient understanding of their function and risks. A SIV is a fund that borrows money by issuing short-term securities at low interest and then lends that money by buying long-term securities at higher interest, making a profit for investors from the difference. A SIV is a type of relatively large structured credit product and invests in a range of asset-backed securities, as well as some financial corporate bonds. A SIV has an open-ended structure in that it plans to stay in business indefinitely by buying new assets as the old ones mature, and the SIV generally exchanges investments without providing investors transparency.

.108 The risk that arises from the transaction is two-fold. First, the solvency of the SIV may be at risk if the value of the long-term security that the SIV has bought falls below that of the short-term securities that the SIV has sold. Second, there is liquidity risk because the SIV borrows short-term and invests long-term—that is, payouts become due before the pay-ins are collected. To provide financial resources for its activities, a government may find itself needing to terminate its position in a SIV. Unless it can find other resources, the government may be forced to sell its position in a SIV into a depressed market.

.109 The subprime mortgage crisis has caused a widespread liquidity crunch in the markets. Investors have become reluctant to invest as the crisis spreads. A number of SIVs have fallen victim to the lack of liquidity, whereas others received support from a sponsoring bank.

.110 Auditors of state and local government-holding investments in SIVs should obtain a thorough understanding of the investment vehicle and place a particular audit focus on the risks associated with the
investment (collateral). Because of the complexity of these investment instruments, auditors should give due consideration to involving specialists in the audit engagement to assist in this evaluation.

**Pensions, OPEB, and the Use of Specialists**

.111 Upon the effective dates of GASB Statement No. 43, No. 45, and No. 50, *Pension Disclosures—An Amendment of GASB Statements No. 25 and No. 27*, defined benefit OPEB plans, defined benefit pension plans, and certain government employers are required to disclose, among other things, information about the funded status and funding progress of the plans as of the most recent actuarial valuation date in the notes to the financial statements. Such information includes, but is not limited to, the actuarial valuation date, actuarial assumptions, actuarial value of assets, the actuarial accrued liability, the total unfunded actuarial accrued liability, and the annual covered payroll. Most of these governments will use the services of an actuary in the valuation of the OPEB plan and determination of annual required contributions and annual OPEB costs and liabilities. Prior to these new standards, the funded status and funding progress of defined benefit pension plans was reported solely in required supplementary information (RSI). Under professional standards, the auditor has a greater responsibility for information disclosed in the notes to the financial statements than for information reported in RSI. Because auditors may not have actuarial knowledge, they may rely on information provided by plan actuaries. As a result, AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), will have particular importance to the auditor of state and local government financial statements when such government provides pensions and OPEBs and uses actuarial services for determination of financial statement amounts and disclosures. Paragraph .12 of AU section 336 states that, while determining the appropriateness and reasonableness of the methods and assumptions used, and their application is the responsibility of the actuary, the auditor should 

- (a) obtain an understanding of the methods and assumptions used by the specialist,
- (b) make appropriate tests of data (such as census data) provided to the specialist, and
- (c) evaluate whether the specialist’s findings support the related assertions in the financial statements.

.112 The auditor might consider it necessary to retain a specialist to assist in evaluating the work of the plan actuary.

.113 Some example procedures for the auditor’s consideration in meeting the requirements of paragraph .12 of AU section 336 regarding the entity’s use of an actuary could include the following:

- Obtaining an understanding of the actuary’s objectives, scope of work, actuarial methods, actuarial assumptions, and source and calculation methodology of health care cost trends within the acceptable parameters of the GASB statements
- Making appropriate tests of data provided to the actuary by considering the reliability and completeness of the plan census data and source of discount rates used
- Evaluating whether the actuary’s findings support the related assertions in the financial statements by understanding what benefits are included in the substantive plan, the policy for contributions, and how plan investments are valued

**Pollution Remediation**

.114 GASB Statement No. 49, *Accounting and Reporting for Pollution Remediation Obligations*, addresses accounting and financial reporting standards for pollution remediation obligations, which are obligations to address the current or potential detrimental effects of existing pollution by participating in pollution remediation activities such as site assessments and clean-ups. It is effective for financial statements for periods beginning after December 15, 2007, with measurement of pollution remediation liabilities required as of the beginning of the period so that the beginning balance of net assets can be restated. Of particular concern to

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2 In January 2009 the Auditing Standards Board (ASB) issued exposure drafts of proposed Statements on Auditing Standards (SASs) *Other Information in Documents Containing Audited Financial Statements, Other Information in Relation to the Financial Statements as a Whole, and Required Supplementary Information*. These SASs would amend or supersede AU section 550, *Other Information in Documents containing Audited Financial Statements*, AU section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, and AU section 558, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1), respectively, in order to apply the ASB’s clarity drafting conventions. If approved, these SASs would be effective for fiscal years beginning after December 15, 2009.
auditors of state and local government financial statements are the assertions of existence, completeness, and valuation. Because of the difficulty in obtaining sufficient legal letter representations regarding these potential obligations, the auditor should generally consider the existence, completeness, and valuations assertions as possessing a relatively high inherent risk of misstatement when performing risk assessment procedures. Many governments will engage the services of a remediation specialist to estimate potential pollution remediation outlays and the related probabilities. AU section 336, as discussed in the preceding paragraphs, will also have particular importance to the auditor of state and local government financial statements in relation to pollution remediation obligations. See additional discussion of GASB Statement No. 49 in the “Accounting Issues and Developments” section of this alert.

**Information Technology Internal Control Issues**

.115 The implementation of the risk-based auditing standards defined the responsibilities of auditors to document their understanding of internal control surrounding how an entity initiates, authorizes, records, processes, and reports transactions and financial data. Many larger governmental entities have been using complex IT systems for years and, during this time, their systems and transaction flows have been documented for both manual systems and IT-dependent systems. Due to the current economic situation, auditors may want to assess the resources that have been allocated to IT at governmental entities. This would include the quality of documentation as well as the experiences of the resources in addressing the IT issues at the audited entity.

.116 Further, a complex IT environment can exist in any government, regardless of the size of the entity. The government’s use of IT may affect any of the five components of internal control in addition to the government’s operating and business functions. For example, the government may use an IT system that is highly complex and integrated through all functions and services of the entity; these systems may share data and support all aspects of financial reporting. Alternatively, the government may use one application only for the accounts receivable function or for utility billings. The auditor is required to document key elements of internal control surrounding the IT environment. Additionally, AU section 314 states that an auditor may determine that it is necessary to include a specialist to work on the audit team to assist with the determination of the complexities and intricacies of an entity whose use of IT is extensive.

.117 Of particular concern are the risks when there is a lack of segregation of duties over IT functions or over accounting functions in the accounting application. Segregation of duties issues may arise due to a reduction in the IT staff at a larger entity or due to the more limited staff of a smaller entity. Regardless of the reason, the extent and nature of these control risks vary depending on the nature and characteristics of the entity’s information system. For example, multiple users, either external or internal, may access a common database of information that affects financial reporting. In such circumstances, a lack of an effective control at a single user entry point might compromise the security of the entire database, potentially resulting in unauthorized changes to or destruction of data which could affect the financial statements. The auditor should consider whether the entity has responded adequately to the risks arising from IT by establishing effective controls, including effective general controls upon which application controls depend. From the auditor’s perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data that such systems process.

.118 Further guidance can be found in the AICPA Information Technology Center at http://infotech.aicpa.org/.

**Auditing Accounting Estimates**

.119 As noted in paragraph .04 of AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements as a whole. In the context of a governmental audit, the overall financial statement level would be at the level of the opinion units as discussed in paragraph 4.32 of the AICPA Audit and Accounting Guide *State and Local Governments*. It is important to remember many types of accounting estimates exist in client financial statements. Some examples include the allowance for
uncollectible accounts receivable, impairment analysis and estimated useful lives of long-lived assets, and actuarial assumptions in pension and other postretirement benefit costs.

120 Given the current economic climate, additional skepticism should be exercised when considering management’s underlying assumptions used in accounting estimates. When evaluating accounting estimates, the auditor should consider both the subjective and objective factors with professional skepticism. As discussed in paragraph .09 of AU section 342, key factors and assumptions that the auditor normally concentrates on include the assumptions that are significant to the estimate, sensitive to variations, deviate from historical patterns, or are particularly subjective and susceptible to misstatement and bias; however, it is important to consider whether historical patterns are still applicable.

121 For example, in the current slow market, new patterns may emerge. In this economic climate, with possible increasing pressure on management to meet budget, a key aspect of AU section 342 is for an auditor to determine the reasonableness of management’s accounting estimates with an extra degree of professional skepticism. As noted in AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), when assessing audit differences between client estimates and audit estimates, even if they are individually reasonable, an auditor should consider whether these differences are indicative of possible bias by management. If so, the auditor should reconsider the estimates as a whole.

122 The auditor should obtain an understanding of how management develops estimates and employ one of the approaches outlined in paragraph .10 of AU section 342 in testing that process. In reviewing and testing management’s process, the auditor may consider identifying controls around this process and determining if the underlying data used for the estimate are reliable and used appropriately. An auditor also may develop an estimate and compare it to management’s estimate. Lastly, the auditor may review subsequent events or transactions occurring prior to the date of the auditor’s report. Further, as noted in AU section 316, hindsight may provide the auditor additional insight into the existence of management bias. For further details on auditing estimates, see AU section 342.

Consideration of Fraud in a Financial Statement Audit

123 AU section 316 is the primary source of authoritative guidance about an auditor’s responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, as stated in paragraph .02 of AU section 110, Responsibilities and Functions of the Independent Auditor (AICPA, Professional Standards, vol. 1).

124 The three following conditions generally are present when fraud occurs:

- Management or other employees have an incentive or are under pressure, which provides a reason to commit fraud.
- Circumstances exist (for example, the absence of controls, ineffective controls, or the ability of management to override controls) that provide an opportunity for a fraud to be perpetrated.
- Those involved are able to rationalize committing a fraudulent act.

125 The current economic situation may result in unexpected losses and possibly cause financing or liquidity difficulties for many entities. Additionally, management may be valuing many illiquid securities using inherently subjective methodologies. These situations may provide management additional opportunity and incentive to commit fraud.

126 As seen in the news recently, a number of frauds that include the three previously mentioned conditions allegedly have occurred. One of those frauds is that of Bernard Madoff Investment Securities. Although the details of this fraud are just beginning to be investigated, auditors should ensure that they are properly testing for the existence of assets, such as investments, in this scenario. Additionally, auditors should always gain an understanding of the entity’s business and how profits are made. In the Madoff case, auditors
are being probed about failing to question the strong, consistent annual returns by these investment funds that lacked a clear investment strategy. Because of the characteristics of fraud, the auditor’s exercise of professional skepticism is important when considering the risks of material misstatement due to fraud.

.127 Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor’s belief about management’s honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. AU section 316 provides additional information, including ways for the auditor to respond to the risk of material misstatement due to fraud.

Evaluating the Existence of Assets

.128 The Madoff case, and other alleged frauds, brings to light a number of risks that continually need to be considered and responded to by management and auditors. Due to the nature of securities and other financial instruments, determining and testing the ownership and existence of investments has become more difficult. Often, securities and other investments purchased on behalf of an entity are held in the name of a broker organization, which may or may not be a custodian; and generally, custodians do not obtain a paper document anymore, only an electronic record of the assets.

.129 Some examples of risks inherent in investment transactions that may be relevant when assessing existence are as follows:

- The assets involved may not be readily available to physical inspection.
- There could be a lack of effective, independent, third party oversight.
- The information received from a broker organization, in the form of monthly statements or in response to audit confirmation requests, may require further verification to assess its reliability.
- There may be a lack of experience on the part of the client with these types of transactions and, therefore, controls over existence may be nonexistent or poorly designed.
- The transactions may be complex in nature, making them difficult to understand.

.130 Management has a responsibility to design an internal control system that is responsive to the risk of existence of assets (in addition to the valuation of assets). As part of their risk assessment procedures, auditors need to assess those controls and determine if the controls have been implemented. Depending on the results of those assessments, the auditor should design an audit strategy that takes into consideration the entity’s controls, including testing those controls if those controls are to be relied upon and used as part of the auditor’s audit evidence regarding the existence assertion. If the auditor’s assessment indicates that management’s design or operation of controls are not effective, then those deficiencies should be communicated to those charged with governance if the control deficiency is a significant deficiency or material weakness.

.131 Examples of procedures that management can perform that are designed to assess the existence of assets could include the following:

- Obtaining through site visits (and then documenting) an understanding of existence controls placed in operation by any service organization that is utilized by the entity and periodically reassessing that understanding
- Obtaining evidence, through direct testing or a SAS 70 type 2 report, that the service organization’s existence controls are appropriately designed and operating effectively
- Inspecting other documentation supporting the entity’s interest in the security (for example, correspondence from the broker organization or trustee acknowledging transactions with the fund)
Communication With Those Charged With Governance

.132 In addition to instances in which communication with those charged with governance in other auditing sections is discussed, other select measures are outlined in AU section 380, *The Auditor’s Communication With Those Charged With Governance* (AICPA, Professional Standards, vol. 1), that are specifically relevant during an economic crisis and when measuring fair value. AU section 380 establishes standards and provides guidance on the auditor’s communication with those charged with governance. As noted in paragraph .05 of AU section 380, the auditor must communicate with those charged with governance matters related to the financial statement audit that are, in the auditor’s professional judgment, significant and relevant to the responsibilities of those charged with governance in overseeing the financial reporting process. The auditor should communicate his or her views about the quality of the entity’s significant accounting policies, accounting estimates, and financial statement disclosures. Paragraph .51 of AU section 380 states that the auditor should communicate significant findings from the audit (see paragraphs .34–.35 of AU section 380) in writing when, in the auditor’s professional judgment, oral communication would not be adequate.

.133 AU section 341, *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern* (AICPA, Professional Standards, vol. 1), expands on the applicability of AU section 380 when the auditor has concluded that substantial doubt exists about the entity’s ability to continue as a going concern. In that case, the auditor should communicate to those charged with governance the nature of the events or conditions identified, the possible effect on the financial statements, the sufficiency of the related disclosures, and the effects on the auditor’s report.

Communicating Internal Control Related Matters Identified in an Audit

.134 In October 2008 the AICPA Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, Professional Standards, vol. 1, AU sec. 325). SAS No. 115 amends SAS No. 112 and further clarifies standards and provides guidance on communicating matters related to an entity’s internal control over financial reporting (internal control) identified in an audit of financial statements.

.135 The new SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) except when the auditor is performing an integrated audit and will be expressing an opinion on the effectiveness of internal control over financial reporting under AT section 501, *An Examination of an Entity’s Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, Professional Standards, vol. 1). This new standard is effective for audits of financial statements for periods ending on or after December 15, 2009, with early implementation permitted.

.136 In general, SAS No. 115 retains many of the provisions of SAS No. 112; it provides guidance to (a) enhance the auditor’s ability to identify and evaluate deficiencies in internal control during an audit, and then (b) communicates to management and those charged with governance those deficiencies that the auditor believes are significant deficiencies or material weaknesses.

.137 The key differences between SAS No. 115 and SAS No. 112 lie in the definitions of *material weaknesses* and *significant deficiencies* and the process for making that determination. Under SAS No. 112, the auditor applied criteria of likelihood and magnitude described in that standard to determine if a control deficiency reached the threshold of significant deficiency or material weakness. Under SAS No. 115, the same criteria are used; however, more judgment is allowed for in determining whether a control deficiency is a significant deficiency.

Definitions of Significant Deficiency and Material Weakness

.138 A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis. For the purpose of this definition, a reasonable...
possibility exists when the likelihood of the event is either *reasonably possible* or *probable* as those terms are used in FASB Statement No. 5, *Accounting for Contingencies*.  

**.139** A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

### The Evaluation Process

**.140** Although the auditor is not required to perform procedures specifically to identify deficiencies in internal control, during the course of the audit, the auditor may become aware of deficiencies in the design or operation of the entity’s internal control. The auditor should evaluate the severity of each deficiency in internal control identified during the audit and determine whether the deficiency, individually or in combination with other deficiencies in internal control, rise to the level of significant deficiencies or material weaknesses. The severity of a deficiency in internal control depends on

- the magnitude of the potential misstatement resulting from the deficiency or deficiencies; and
- whether a reasonable possibility exists that the entity’s controls will fail to prevent or to detect and correct a misstatement of an account balance or disclosure.

**.141** The severity of a deficiency does not depend on whether a misstatement actually occurred. If the auditor identifies a deficiency in internal control but has not identified an actual misstatement related to that deficiency, the auditor cannot automatically conclude that the deficiency is not a significant deficiency or a material weakness. If a misstatement has been identified, the auditor should consider the potential for further misstatement in the financial statements being audited.

**.142** The AICPA published Audit Risk Alert *Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115* (product no. 022539kk) to assist in understanding the requirements of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

### The Applicability of SAS No. 115 to Yellow Book and Single Audits

**.143** The GAO has issued interim guidance on reporting on internal control over financial reporting, making it permissible for auditors to implement SAS No. 115 on their financial statement audits performed under *Government Auditing Standards*. For the full text of the GAO interim guidance related to SAS No. 115, go to www.gao.gov/govaud/icguidance0811.pdf. This guidance becomes effective concurrently with the auditor’s implementation of SAS No. 115. However, OMB has not provided any guidance to date regarding use of the new guidance and definitions in SAS No. 115 for reporting on internal control over compliance in single audits. Therefore, it would not be appropriate for auditors to use definitions for reporting on internal control over compliance as found in SAS No. 115 until such time that OMB guidance is amended to allow usage of these new definitions. Readers should monitor the OMB Web site for further guidance at www.whitehouse.gov/omb and look to the Governmental Audit Quality Center Web site (www.aicpa.org/GAQC) for additional updates.

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*The term reasonably possible, as used in the definitions of the term material weakness, has the same meaning as defined in Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*. Paragraph 3 of FASB Statement No. 5 states

When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms probable, reasonably possible, and remote to identify three areas within that range, as follows:

a. Probable. The future event or events are likely to occur.

b. Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.

c. Remote. The chance of the future event or events occurring is slight.

Therefore, the likelihood of an event is a reasonable possibility when it is reasonably possible or probable.

* At the time of this writing, the FASB *Accounting Standards Codification™* (ASC) had not yet been issued as authoritative. When the FASB ASC is issued as authoritative, the definitions currently found in FASB Statement No. 5 will be located at FASB ASC 450-20-25-1.
Accounting Issues and Developments

GASB Accounting Standards Upcoming Implementation Dates

.144 A number of GASB pronouncements issued prior to 2008 have provisions with effective dates for fiscal periods ending in 2009 and 2010. These pronouncements and applicable implementation provisions are highlighted as follows.

GASB Statement No. 43, Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans

.145 This statement establishes standardized financial reporting standards for OPEB plans. The standards in this statement apply for OPEB trust funds included in the financial statements of plan employers, as well as for the outside financial statements of OPEB plans or the employee retirement systems, or other third parties that oversee them. Requirements for reporting of OPEB funds by administrators of multiple-employer OPEB plans is also described in this statement when the fund used to accumulate assets and pay benefits or premiums when due is not a trust fund.

.146 The requirements of GASB Statement No. 43 for an OPEB plan are effective one year prior to the effective date of the related GASB Statement No. 45 for the employer (single-employer plan) or for the largest participating employer in the plan (multiple-employer plan). The requirements of GASB Statement No. 45 are effective in three phases based on a government’s implementation phase for the purpose of GASB Statement No. 34, Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments. (See preceding explanation of phase 1, 2, and 3 governments in the GASB Statement No. 34 discussion.) Plans in which the sole or largest participating employer was a phase 1 government, for the purpose of implementation of GASB Statement No. 34, were required to apply the requirements of GASB Statement No. 43 in financial statements for periods beginning after December 15, 2005. Plans in which the sole or largest participating employer was a phase 2 government, for the purpose of implementation of GASB Statement No. 34, were required to apply the requirements of GASB Statement No. 43 in financial statements for periods beginning after December 15, 2006. Plans in which the sole or largest participating employer was a phase 3 government, for the purpose of implementation of GASB Statement No. 34, should apply the requirements of GASB Statement No. 43 in financial statements for periods beginning after December 15, 2007. Early implementation of GASB Statement No. 43 is encouraged.

GASB Statement No. 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions

.147 This statement establishes standards of accounting and financial reporting for OPEB expense/expenditures and related liabilities or assets, note disclosures, and RSI in the financial statements of state and local governmental employers.

.148 The requirements of GASB Statement No. 45 are effective in three phases. Governments that were phase 1 governments, for the purpose of implementation of GASB Statement No. 34, should apply the requirements of GASB Statement No. 45 in financial statements for periods beginning after December 15, 2006. Governments that were phase 2 governments, for the purpose of implementation of GASB Statement No. 34, should apply the requirements of GASB Statement No. 45 in financial statements for periods beginning after December 15, 2007. Governments that were phase 3 governments, for the purpose of implementation of GASB Statement No. 34, should apply the requirements of GASB Statement No. 45 in financial statements for periods beginning after December 15, 2008. All component units are required to implement the requirements of GASB Statement No. 45 no later than the same year as their primary government.
GASB Statement No. 49, Accounting and Financial Reporting for Pollution Remediation Obligations

.149 This statement addresses accounting and financial reporting standards for pollution remediation obligations, which are obligations to address the current or potential detrimental effects of existing pollution by participating in pollution remediation activities, such as site assessments and clean-ups. Governments are required to assess pollution remediation obligations for recognition when any of five obligating events occurs. Obligations are measured using expected cash flows and generally will be recognized as an expense and liability but may qualify for capitalization if certain criteria are met. Certain types of recoveries affect measurement. The scope of the statement excludes pollution prevention or control obligations with respect to current operations and future pollution remediation activities that are required upon retirement of an asset, such as landfill closure and postclosure care and nuclear power plant decommissioning.

.150 GASB Statement No. 49 is effective for financial statements for periods beginning after December 15, 2007, with measurement of pollution remediation liabilities required at the beginning of that period so that beginning net assets can be restated. However, governments that have sufficient objective and verifiable information to apply the expected cash flow technique to measure the liability in prior periods are required to apply the provisions retroactively for all such prior periods presented.

GASB Statement No. 51, Accounting and Financial Reporting for Intangible Assets

.151 GASB Statement No. 51, issued in June 2007, provides guidance regarding how to identify, account for, and report intangible assets.

.152 This statement requires that all intangible assets not specifically excluded by its scope provisions be classified as capital assets. Many different types of assets that may be considered intangible assets, including easements, water rights, timber rights, patents, trademarks, and computer software. Intangible assets and, more specifically, easements, are referred to in the description of capital assets in GASB Statement No. 34. This reference created questions about whether and when intangible assets should be considered capital assets for financial reporting purposes. An absence of sufficiently specific authoritative guidance that addresses these questions has resulted in inconsistencies in the accounting and financial reporting of intangible assets among state and local governments, particularly in the areas of recognition, initial measurement, and amortization. The objective of this statement is to establish accounting and financial reporting requirements for intangible assets to reduce these inconsistencies, thereby enhancing the comparability of the accounting and financial reporting of such assets among state and local governments.

.153 Existing authoritative guidance related to the accounting and financial reporting for capital assets should be applied to these intangible assets, as applicable. This statement also provides authoritative guidance that specifically addresses the nature of these intangible assets. Such guidance should be applied in addition to the existing authoritative guidance for capital assets.

.154 This statement requires that an intangible asset be recognized in the statement of net assets only if it is considered identifiable. Additionally, this statement establishes a specified-conditions approach to recognizing intangible assets that are internally generated. Effectively, outlays associated with the development of such assets should not begin to be capitalized until certain criteria are met. Outlays incurred prior to meeting these criteria should be expensed as incurred. This statement also provides guidance on recognizing internally generated computer software as an intangible asset. This guidance serves as an application of the specified-conditions approach to the development cycle of computer software.

.155 This statement also establishes guidance related to the amortization of intangible assets within its scope. This statement provides guidance on determining the useful life of intangible assets when the length of their life is limited by contractual or legal provisions. If there are no factors that limit the useful life of an intangible asset, the statement provides that the intangible asset be considered to have an indefinite useful life. Intangible assets with indefinite useful lives should not be amortized unless their useful life is subsequently determined to no longer be indefinite due to a change in circumstances.
The requirements of this statement are effective for financial statements for periods beginning after June 15, 2009; early implementation is encouraged. The provisions of this statement generally are required to be applied retroactively. For governments that were classified as phase 1 or phase 2 governments for the purpose of implementing GASB Statement No. 34, retroactive reporting is required for intangible assets acquired in fiscal years ended after June 30, 1980, except for those considered to have indefinite useful lives as of the effective date of this statement and those that would be considered internally generated. Retroactive reporting of intangible assets by phase 3 governments is encouraged but not required. Retroactive reporting is not required but is permitted for intangible assets considered to have indefinite useful lives as of the effective date of this statement and those considered to be internally generated.

**GASB Statement No. 52, Land and Other Real Estate Held as Investments by Endowments**

In November 2007 GASB issued GASB Statement No. 52, which establishes consistent accounting and financial reporting standards for land and other real estate held as investment by endowments, including permanent funds. These investments will likely be encountered more often in colleges and universities and their related foundations than general-purpose governments. Endowments generally exist to invest resources for the purpose of generating income.

This statement requires that land and other real estate held as investments by endowments be reported at fair value and the changes in fair value reported as investment income.

This statement is effective for financial statements for periods beginning after June 15, 2008. Earlier application is encouraged.

**Recently Issued GASB Pronouncements and Related Guidance**

The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. The AICPA Comprehensive Audit Risk Alert (product no. 022339kk) and other AICPA industry-specific alerts also contain summaries of recent nongovernmental accounting pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or visit www.cpa2biz.com.

**GASB Statement No. 56, Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards**

GASB Statement No. 56, issued in March 2009, incorporates into GASB authoritative literature certain accounting and financial reporting guidance presented in the AICPA’s SASs. This statement addresses three issues not included in the GASB authoritative accounting literature that establishes accounting principles—related party transactions, going concern considerations, and subsequent events.

Although not intended to change practice, certain provisions of GASB Statement No. 56 differ from the AU sections of AICPA Professional Standards from which they were derived. For example, GASB Statement No. 56 specifies an evaluation by management of a government’s ability to continue as a going concern for a period of 12 months beyond the financial statement date plus any period shortly thereafter about which there is a current doubt. Paragraph .03 of AU section 341 specifies that the auditor should evaluate whether there is substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time.

Other sections of AICPA Professional Standards that are incorporated into this statement are AU section 334, Related Parties (AICPA, Professional Standards, vol. 1), and AU section 560. GASB Statement No. 56 became effective upon issuance.
GASB Statement No. 55, The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments

.164 GASB Statement No. 55, issued in March 2009, incorporates the hierarchy GAAP for state and local governments into GASB authoritative literature. It is intended to make it easier for preparers of state and local government financial statements to identify and apply the GAAP hierarchy, which consists of sources of accounting principles used in the preparation of financial statements so that they are presented in conformity with GAAP and the framework for selecting those principles. Like GASB Statement No. 56, this statement contributes to GASB’s efforts to codify all GAAP for state and local governments so that they derive from a single source.

.165 Prior to the statement, the GAAP hierarchy was set forth in SAS No. 69, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, Professional Standards, vol. 1, AU sec. 411), rather than in the authoritative accounting literature of GASB. GASB Statement No. 55 moves relevant portions of that SAS to GASB literature without substantive changes. GASB does not anticipate that this statement will result in a change in current practice. GASB Statement No. 55 became effective upon issuance.

GASB Statement No. 54, Fund Balance Reporting and Governmental Fund Type Definitions

.166 GASB Statement No. 54, issued in March 2009, initially distinguishes fund balance between amounts that are considered nonspendable, such as fund balance associated with inventories, and other amounts that are classified as spendable based on the relative strength of the constraints that control the purposes for which specific amounts can be spent. Beginning with the most binding constraints, fund balance amounts will be reported in the following classifications:

- Restricted—Amounts that can be spent only for the specific purposes stipulated by constitution, external resource providers, or through enabling legislation.
- Committed—Amounts that can be used only for the specific purposes determined by a formal action of the government’s highest level of decision-making authority.
- Assigned—Amounts intended to be used by the government for specific purposes but do not meet the criteria to be classified as restricted or committed.
- Unassigned—The residual classification for the government’s general fund and includes all spendable amounts not contained in the other classifications.

.167 The new standards also clarify the definitions of individual governmental fund types. It interprets certain terms within the definition of special revenue fund types as well as further clarifying the debt service and capital projects fund type definitions. The final standard also specifies how economic stabilization or “rainy day” amounts should be reported. Because of the specific nature of these types of accounts, the statement considers stabilization amounts as specific purposes. Stabilization amounts should be reported in the general fund as restricted or committed if they meet the appropriate criteria. Only if the resources in the stabilization arrangement derive from a restricted or committed revenue source could a stabilization fund be reported as a special revenue fund.

.168 The definitions of the general fund, special revenue fund type, capital projects fund type, debt service fund type, and permanent fund type are clarified by the statement. The capital projects fund type was clarified for better alignment with the needs of preparers and users. Definitions are as follows:

**General fund.** Account for and report all financial resources and uses not accounted for and reported in another fund.

**Special revenue funds.** Account for and report the proceeds of specific revenue sources that are restricted or committed to expenditure for specified purposes other than debt service or capital projects.

**Capital projects funds.** Account for and report financial resources that are restricted, committed, or assigned to the expenditure for capital outlays, including the acquisition of construction of capital facilities and other capital assets.
Debt service funds. Account for and report financial resources that are restricted, committed, or assigned to expenditure for principal and interest.

Permanent funds. Account for and report resources that are restricted to the extent that only earnings, and not principal, may be used for purposes that support the reporting government’s programs, that is, for the benefit of the government or its citizenry.

.169 For governments that use encumbrance accounting, significant encumbrances should be disclosed in the notes to the basic financial statements by major funds in the aggregate in conjunction with disclosures about other significant commitments. They should not be separately displayed within committed, assigned, or restricted categories.

.170 GASB Statement No. 54 is effective for financial statements for periods beginning after June 15, 2010. Earlier application is encouraged. Fund balance reclassifications made to conform to GASB Statement No. 54 should be retroactively applied by restating fund balance for all prior periods presented.

GASB Statement No. 53, Accounting and Financial Reporting for Derivative Instruments

.171 GASB Statement No. 53, issued in June 2008, addresses the recognition, measurement, and disclosure of information regarding derivative instruments entered into by state and local governments. Derivative instruments are often complex financial arrangements used by governments to manage specific risks or to make investments. By entering into these arrangements, governments receive and make payments based on market prices without actually entering into the related financial or commodity transactions. Derivative instruments associated with changing financial and commodity prices result in changing cash flows and fair values that can be used as effective risk management or investment tools. Derivative instruments, however, also can expose governments to significant risks and liabilities. Common types of derivative instruments used by governments include interest rate and commodity swaps, interest rate locks, options (caps, floors, and collars), swaptions, forward contracts, and futures contracts.

.172 Governments enter into derivative instruments as investments; as hedges of identified financial risks associated with assets or liabilities or expected transactions (that is, hedgeable items); or to lower the costs of borrowings. Governments often enter into derivative instruments with the intention of effectively fixing cash flows or synthetically fixing prices. For example, a government with variable rate debt may enter into a derivative instrument designed to synthetically fix the debt’s interest rate, thereby hedging the risk that rising interest rates will negatively affect cash flows. Governments also enter into derivative instruments to offset the changes in fair value of hedgeable items.

.173 A key provision in this statement is that derivative instruments covered in its scope, with the exception of synthetic guaranteed investment contracts that are fully benefit-responsive, are reported at fair value. For many derivative instruments, historical prices are zero because their terms are developed so that the instruments may be entered into without a payment being received or made. The changes in fair value of derivative instruments that are used for investment purposes or that are reported as investment derivative instruments because of ineffectiveness are reported within the investment revenue classification. Alternatively, the changes in fair value of derivative instruments that are classified as hedging derivative instruments are reported in the statement of net assets as deferrals.

.174 Derivative instruments associated with hedgeable items that are determined to be effective in reducing exposures to identified financial risks are considered hedging derivative instruments. Effectiveness is determined by considering whether the changes in cash flows or fair values of the potential hedging derivative instrument substantially offset the changes in cash flows or fair values of the hedgeable item. In these instances, hedge accounting should be applied. Under hedge accounting, the changes in fair values of the hedging derivative instrument are reported as either deferred inflows or deferred outflows in a government’s statement of net assets.

.175 GASB Statement No. 53 describes the methods of evaluating effectiveness. The consistent critical terms method considers the terms of the potential hedging derivative instrument and the hedgeable item.
relevant terms match, or in certain instances, are similar, a potential hedging derivative instrument is
determined to be effective. The other methods are based on quantitative analyses. The synthetic instrument
method considers whether a fixed rate or price has been established within a prescribed range. The
dollar-offset method evaluates changes in expected cash flows or fair values over time between the potential
hedging derivative instrument and the hedgeable item. The regression analysis method considers the
relationship between changes in the cash flows or fair values of the potential hedging derivative instrument
and the hedgeable item. In these methods, critical and quantitative values are evaluated to determine whether
a potential hedging derivative instrument is effective. Quantitative methods other than those specified in the
statement are permitted, provided that they address whether the changes in cash flows or fair values of the
potential hedging derivative instrument substantially offset the changes in cash flows or fair values of the
hedgeable item.

The disclosures previously required by GASB Technical Bulletin (TB) No. 2003-1, Disclosure Require-
ments for Derivatives Not Reported at Fair Value on the Statement of Net Assets, have been incorporated into GASB
Statement No. 53 and, therefore, GASB TB 2003-1 is superseded upon implementation of GASB Statement No.
53. The objectives, terms, and risks of hedging derivative instruments are required disclosures. Disclosures
also include a summary of derivative instrument activity that provides an indication of the location of fair
value amounts reported on the financial statements. The disclosures for investment derivative instruments are
similar to the disclosures of other investments.

GASB Statement No. 53 is effective for financial statements for periods beginning after June 15, 2009. Earlier
application is encouraged. For potential hedging derivative instruments existing prior to the fiscal
period during which this statement is implemented, the evaluation of effectiveness should be performed as
of the end of the current period. If determined to be effective, hedging derivative instruments are reported
as if they were effective from their inception. If determined to be ineffective, the potential hedging derivative
instrument is then evaluated as of the end of the prior reporting period. A comprehensive implementation
guide to GASB Statement No. 53 was released by GASB in April 2009.

GASB Statement No. 53, Service Efforts and Accomplishments Reporting—an
amendment of GASB Concepts Statement No. 2

GASB Concepts Statement No. 5, issued in November 2008, updates provisions in GASB Concepts
Statement No. 2 in order to reflect developments that have occurred since GASB Concepts Statement No. 2
was issued in 1994. The proposed changes are based on the findings of extensive research by GASB and others
and the results of GASB monitoring of state and local governments that have been using and reporting service
efforts and accomplishments (SEA) performance information.

The revisions to GASB Concepts Statement No. 2 clarify that it is beyond the scope of GASB to
establish the goals and objectives of state and local government services, to develop specific nonfinancial
measures or indicators of service performance, or to set benchmarks for service performance. To emphasize this point, GASB Concepts Statement No. 5 removes the entire section of Concepts Statement No. 2, “Developing Reporting Standards for SEA Information.” GASB Concepts Statement No. 2 also was amended to update terminology and to modify certain provisions to reflect what has taken place over the past 14 years.

**FASB Accounting Standards Codification™**

.182 State and local government auditors should take note of the FASB project to codify its accounting standards. GASB Statement No. 34 states that governmental and business-type activities and proprietary funds should be reported based on all applicable GASB pronouncements, as well as FASB Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedure issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. As a result, financial statement preparers have the responsibility to identify which provisions within the FASB pronouncements are applicable to them, while disregarding any amendments to such pronouncements made after that date.

.183 FASB is expected to release FASB Accounting Standards Codification™ (ASC) on July 1, 2009, at which time it will become the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. FASB ASC will supersede all then-existing, non-SEC accounting and reporting standards for nongovernmental entities. Once effective, all other nongrandfathered, non-SEC accounting literature not included in FASB ASC will become nonauthoritative. This change will affect accountants and auditors alike.

.184 FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing all authoritative literature in a topically organized structure. FASB ASC disassembled and reassembled thousands of nongovernmental accounting pronouncements (including those of FASB, the Emerging Issues Task Force [EITF], and the AICPA) to organize them under approximately 90 topics. FASB ASC includes all accounting standards issued by a standard setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, EITF, AICPA, and related literature. FASB ASC also includes relevant portions of authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance issued by the SEC; however, FASB ASC is not the official source of SEC guidance and does not contain the entire population of SEC rules, regulations, interpretive releases, and staff guidance.

.185 FASB ASC is not intended to change U.S. GAAP or any requirements of the SEC; rather, it is part of FASB’s efforts to reduce the complexity of accounting standards and also to facilitate international convergence. Moreover, FASB ASC does not include governmental accounting standards.

.186 Identifying the FASB pronouncements applicable to governments within the codification of the FASB standards will not be possible because the standards are presented in the codification as amended and have been reorganized, together with literature from all levels of the U.S. GAAP hierarchy, including pronouncements and other related literature, which was not made applicable to state and local governments in GASB Statement No. 34. However, the original pronouncements will be available for reference in the archive section on the FASB Web site. GASB has a project on its current technical agenda to codify pre-November 30, 1989 FASB pronouncements that are applicable to governments as part of GASB’s GAAP. See the “Accounting Pipeline” section of this alert for more information about the GASB project.

.187 The AICPA has published Financial Reporting Alert FASB Codification Developments—2008 (product no. 029209kk). This Financial Reporting Alert is intended to provide a better understanding of FASB ASC, outline its structure, and provide case studies on navigating the FASB ASC Research System and performing accounting research.
Recent Pronouncements

.188 AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. For information on pronouncements issued subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org, the GASB Web site at www.gasb.org, and the GAO Web site at www.gao.gov. You also may look for announcements of newly issued accounting standards in the CPA Letter and the Journal of Accountancy.

Recent Auditing and Attestation Pronouncements and Related Guidance

.189 The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

<table>
<thead>
<tr>
<th>Recent Auditing and Attestation Pronouncements and Related Guidance</th>
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<tbody>
<tr>
<td><strong>Statement on Auditing Standards (SAS)</strong></td>
</tr>
<tr>
<td>Issue Date: February 2009 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])</td>
</tr>
<tr>
<td>This standard amends AU section 722 to accommodate reviews of interim financial information of nonissuers, including companies offering securities pursuant to Securities and Exchange Commission (SEC) Rule 144A or participating in private equity exchanges. It is effective for reviews of interim financial information for interim periods beginning after December 15, 2009. Earlier application is permitted.</td>
</tr>
<tr>
<td><strong>SAS No. 115, Communicating Internal Control Related Matters Identified in an Audit</strong> (AICPA, Professional Standards, vol. 1, AU sec. 325)</td>
</tr>
<tr>
<td>Issue Date: October 2008 (Applicable to audits conducted in accordance with GAAS)</td>
</tr>
<tr>
<td>Replacing SAS No. 112, <em>Communicating Internal Control Related Matters Identified in an Audit</em> (AICPA, Professional Standards, vol. 1, AU sec. 325A) this standard defines the terms <em>deficiency</em> in internal control, <em>significant deficiency</em>, and <em>material weakness</em>; provides guidance on evaluating the severity of deficiencies in internal control identified in an audit of financial statements; and requires the auditor to communicate in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit. It is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.</td>
</tr>
<tr>
<td>Issue Date: October 2008</td>
</tr>
<tr>
<td>This statement establishes requirements and provides guidance that applies when a practitioner is engaged to perform an examination of the design and operating effectiveness of an entity’s internal control over financial reporting (examination of internal control) that is integrated with an audit of financial statements (integrated audit). This SSAE is effective for integrated audits for periods ending on or after December 15, 2008. Earlier implementation is permitted.</td>
</tr>
<tr>
<td>Issue Date: April 2007 Revised Date: November 2008 (Interpretive publication)</td>
</tr>
<tr>
<td>This interpretation of AU section 330 addresses the use of electronic confirmations.</td>
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(continued)
## Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Interpretation No. 7, “Reporting on the Design of Internal Control,” of AT section 101, Attest Engagements (AICPA, Professional Standards, vol. 1, AT sec. 9101 par. .59–.69)</th>
<th>This interpretation of AT section 101 addresses how a practitioner may report on the suitability of the design of an entity’s internal control over financial reporting for preventing or detecting and correcting material misstatements of the entity’s financial statements on a timely basis. Issue Date: December 2008 (Interpretive publication)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technical Questions and Answers (TIS) section 1900.01, “Condensed Interim Financial Reporting by Nonissuers” (AICPA, Technical Practice Aids)</td>
<td>This question and answer indicates that when preparing condensed interim financial statements, nonissuers may analogize to the guidance in Article 10 of SEC Regulation S-X regarding form and content because Accounting Principles Board (APB) Opinion No. 28, Interim Financial Reporting, does not provide a reporting framework. APB Opinion No. 28 is codified primarily at Financial Accounting Standards Board Accounting Standards Codification (FASB ASC) 270, Interim Reporting. Issue Date: January 2009 (Nonauthoritative)</td>
</tr>
<tr>
<td>TIS section 9150.25, “Determining Whether Financial Statements Have Been Prepared by the Accountant” (AICPA, Technical Practice Aids)</td>
<td>This question and answer discusses what an accountant should consider in determining whether he or she has prepared the financial statements of a nonissuer. Issue Date: December 2008 (Nonauthoritative)</td>
</tr>
<tr>
<td>TIS section 1100.15, “Liquidity Restrictions” (AICPA, Technical Practice Aids)</td>
<td>This question and answer discusses auditing and accounting issues related to withdrawal restrictions placed on short-term investments by a money market fund or its trustee. Issue Date: October 2008 (Nonauthoritative)</td>
</tr>
<tr>
<td>TIS sections 8200.05–.16 (AICPA, Technical Practice Aids)</td>
<td>These questions and answers in TIS section 8200, Internal Control, were developed in response to common questions received from members regarding the implementation of SAS Nos. 104–111. Some of the topics include the following: • Consideration of internal controls that are less formal or not documented by the client • Whether the auditor may suggest improvements to a client’s internal control. • Assessing inherent risk in relation to the consideration of control risk • Frequency of walkthroughs that are used as the basis for the auditor’s understanding of internal control • Considerations in obtaining an understanding of, evaluating, and documenting controls that the auditor believes are nonexistent or ineffective • Assessing control risk at the maximum level • Considerations for developing a substantive audit strategy Issue Date: April and May 2008 (Nonauthoritative)</td>
</tr>
</tbody>
</table>
Recent Accounting Pronouncements and Related Guidance

.190 The following table presents a list of recently issued accounting pronouncements and related guidance.

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Governmental Accounting Standards Board (GASB) Statement No. 56 (March 2009)</td>
</tr>
<tr>
<td>GASB Statement No. 55 (March 2009)</td>
</tr>
<tr>
<td>GASB Statement No. 54 (February 2009)</td>
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</tbody>
</table>

Recent AICPA Independence and Ethics Pronouncements

.191 Audit Risk Alert Independence and Ethics Developments—2008 (product no. 022479kk) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

On the Horizon

.192 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about ongoing projects that have particular significance to state and local governments or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.193 The following table lists the various standard setting bodies’ Web sites through which information may be obtained on outstanding projects, including downloading exposure drafts. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard setting bodies for further information.

<table>
<thead>
<tr>
<th>Standard Setting Body</th>
<th>Web Site</th>
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<tbody>
<tr>
<td>AICPA Auditing Standards Board</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/</a></td>
</tr>
<tr>
<td>Financial Accounting Standards Board</td>
<td><a href="http://www.fasb.org">www.fasb.org</a></td>
</tr>
</tbody>
</table>

(continued)
In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the next two or three years, the ASB will be redrafting all of the existing auditing sections contained in the Codification of Statements on Auditing Standards (AU sections of the AICPA’s Professional Standards) to apply the clarity drafting conventions and converge with the International Standards on Auditing issued by the International Auditing and Assurance Standards Board (IAASB). The ASB proposes that, except to address current issues, all redrafted standards will become effective at the same time. Only those standards needing to address current issues would have earlier effective dates. The ASB believes that a single effective date will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. Currently, the date is expected to be for audits of financial statements for periods beginning no earlier than December 15, 2010. This date depends on satisfactory progress being made and will be amended, should that prove necessary. See the explanatory memorandum, “Clarification and Convergence,” and the discussion paper, Improving the Clarity of ASB Standards at www.aicpa.org/Professional+Resources/Accounting+and+Attesting+Standards/Improving+the+Clarity+of+ASB+Standards/default.htm.

Compliance Auditing

In January 2009 the ASB issued a proposed SAS, Compliance Auditing. The proposed SAS would supersede SAS No. 74, Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance (AICPA, Professional Standards, vol. 1, AU sec. 801). The proposed SAS was issued as the direct result of the AICPA’s Compliance Auditing Task Force, which was formed as a result of the President’s Council on Integrity and Efficiency (PCIE) report, Report on National Single Audit Sampling Project.

The proposed SAS clarifies its applicability to, and provides more detailed guidance for, compliance audits. As a result, it is expected that the application of the proposed SAS may change the way an auditor performs a compliance audit. However, how significantly the proposed SAS will affect a firm’s compliance audits will depend on how closely the firm has been following the audit guidance in this guide and adapting existing AICPA SASs to compliance audits.

A summary of the potential effects of the proposed SAS on compliance audits are as follows:

- The proposed SAS presents a more detailed description of auditor requirements than SAS No. 74, which should result in a better understanding of the compliance audit requirements.
- The applicability section of the standard includes compliance audits beyond those performed under OMB Circular A-133 Audits of States, Local Governments, and Non-Profits, such as audits performed under certain federal agency audit guides (for example, HUD guide audits).
The proposed SAS includes in its requirements certain compliance auditing considerations that had previously only been discussed in this audit guide. The inclusion of this material in the standard will result in the guidance being applied to all compliance audits covered by the proposed SAS.

The proposed SAS clarifies the applicability of other AU sections to compliance audits, which may result in practice changes depending on how a firm previously interpreted the applicability of other auditing standards to a compliance audit.

The proposed SAS would apply when an auditor is engaged to perform a compliance audit in accordance with all of the following:

- Generally accepted auditing standards (GAAS)
- The standards for financial audits under Government Auditing Standards
- A governmental audit requirement (defined as a governmental requirement established by law, regulation, rule, or provision of contracts or grant agreements requiring that an entity undergo an audit of its compliance with applicable compliance requirements related to one or more government programs that the entity administers)

As mentioned previously, the proposed SAS encompasses compliance audits beyond those performed under Circular A-133; therefore, more compliance audits will be subject to the requirements of the proposed SAS. The proposed SAS does not apply to the financial statement audit component related to a compliance audit.

Readers may obtain a copy of the proposed SAS and track its current status through the Audit and Attest section of the AICPA’s Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/.

Exposure Draft to Revise Standards for Compilation and Review Engagements

The Accounting and Review Services Committee (ARSC) issued an exposure draft that would revise the standards for compilation and review engagements. The changes would affect the interplay between the standards and independence rules, permitting an accountant to issue a review report on financial statements when the accountant’s independence is impaired by performing nonattest services that were designed to improve the reliability of the client’s financial information.

The draft includes a trio of proposed standards: Framework and Objectives for Performing and Reporting on Compilation and Review Engagements; Compilation of Financial Statements; and Review of Financial Statements. In drafting the proposed standards, the ARSC considered recommendations from the Private Company Practice Section (PCPS) Reliability Task Force. The ARSC and PCPS believe the proposed standards will address many concerns of smaller business owners, users of small business financial statements, and CPAs that serve smaller entities.

The PCPS task force recommended that the ARSC consider revising its standards for situations in which an accountant’s independence is impaired in connection with the performance of a nonattest service relating to the design or operation of an aspect of internal control over financial reporting. These nonattest services help management prepare higher quality or more reliable financial statements.

The proposed standards would also harmonize the AICPA’s review standard with the IAASB’s review standard, International Standard on Review Engagements (ISRE) No. 2400, Engagements to Review Financial Statements.

Significant proposed changes to the Statements on Standards for Accounting and Review Services (SSARs) include the following:

- The introduction of new terms such as moderate assurance, review evidence, and review risk to the review literature to harmonize with international review standards.
• A discussion of materiality in the context of a review engagement.
• A requirement that an accountant establish an understanding with management regarding the services to be performed through a written communication, that is, an engagement letter.
• The establishment of enhanced documentation requirements for compilation and review engagements.
• Guidance for practitioners who are engaged to perform a compilation or review engagement when they have also been engaged to perform nonattest services. The guidance includes reporting requirements for instances in which the accountant’s independence is impaired due to the performance of these services.
• The ability for an accountant to include a general description in the accountant’s compilation report regarding the reason(s) for an independence impairment.

.206 The comment deadline is July 31, 2009. The proposed effective date is for compilations and reviews of financial statements for periods beginning on or after December 15, 2010. Early application would be permitted. For further information on this project, visit www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/ARSC+Reliability+Project.htm.

Accounting Pipeline

Current GASB Projects

.207 GASB currently has a variety of projects in process. Some of these projects are as follows:

• Chapter 9 of the United States Bankruptcy Code project, which will provide accounting and financial reporting guidance for governments that have been granted protection from creditors under Chapter 9 of the United States Bankruptcy Code. The project includes an analysis of the financial reporting consequences for governments that have been granted protection under Chapter 9. “Protection” may include modifications to the terms and conditions of certain of the government’s debt issuances and relief from burdensome provisions of certain executory contracts and unexpired lease commitments.

• Codification of Pre-November 30, 1989, FASB pronouncements, to specifically identify provisions in FASB Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins of the AICPA Committee on Accounting Procedure, issued on or before November 30, 1989 (collectively, the FASB pronouncements) as referenced in paragraph 17 of GASB Statement No. 34, that do not conflict with or contradict GASB pronouncements.

• Conceptual Framework—Recognition and Measurement Attributes, which has two primary objectives:
  — The first objective is to develop recognition criteria for whether information should be reported in state and local governmental financial statements and when that information should be reported.
  — The second objective is to consider the measurement attribute or measurement attributes (for example, historical cost or fair value) that, conceptually, should be used in governmental financial statements. This project ultimately will lead to a Concepts Statement.

• Postemployment Benefit Accounting and Financial Reporting, to consider the possibility of improvements to the existing standards of accounting and financial reporting for postemployment benefits—including pension benefits and OPEB—by state and local governmental employers and by the trustees, administrators, or sponsors of pension or OPEB plans. One objective of this project is to improve accountability, or the transparency of financial reporting, in regard to the financial effects of employers’ commitments and actions related to pension benefits and OPEB. This objective would include improving the information provided to help financial report users assess the degree to which interperiod equity has been achieved. The other objective of this project is to improve the usefulness of information for decisions or judgments of relevance to the various users of the general purpose
external financial reports of governmental employers and pension or OPEB plans. This project currently has an outstanding Invitation to Comment at www.gasb.org.

- Certain Implementation Issues Related to OPEB, to consider whether to modify certain requirements related to the measurement of actuarial liabilities for OPEB by agent employers. The issues relate primarily to the interface between the accounting and financial reporting requirements of GASB Statement Nos. 43 and 45 in regard to agent multiple-employer OPEB plans and specifically include consideration of (1) the timing and frequency of the measurement of actuarial liabilities for OPEB by agent employers and (2) the guidelines regarding use of the alternative measurement method by agent employers with small individual OPEB plans.

- Financial Instruments Omnibus, to consider potential revisions to existing standards regarding financial reporting and disclosure requirements that could address significant issues that have been identified in practice since the issuance of GASB Statement No. 31. This project includes five project elements—external investment pools, custodial credit risk of deposits that participate in deposit placement services, unallocated insurance contracts, interest rate risk disclosures for mutual funds, and reporting realized gains and losses. In addition, the existing portions of GASB Statement No. 53 relating to swap terminations, revenue-based contract exclusions, and investor’s initial rate of return will be addressed.

.208 Readers should be alert for the issuance of due process documents. More information about these and other GASB projects can be found at www.gasb.org/project_pages/index.html.

**Comprehensive Implementation Guide Update**

.209 Annually, GASB publishes the annual update to its *Comprehensive Implementation Guide*. The Comprehensive Implementation Guide consolidates and updates previously issued guides for individual standards and provides current guidance on standards for which no standalone guides have been published.

Help Desk—The *Comprehensive Implementation Guide* can be ordered through GASB’s order department at (800) 748-0659 or via its Web site at www.gasb.org.

**Resource Central**

.210 The following are various resources that practitioners engaged in the state and local government environment may find beneficial.

**Publications**

.211 Practitioners may find the following publications useful. Choose the format best for you—online, print, or CD-ROM.

- Audit and Accounting Guide *State and Local Governments* (2009) (product no. 012669kk [paperback], WGG-XXkk [online with the associated Audit Risk Alert], or DGG-XXkk [CD-ROM])
- Audit and Accounting Guide *Health Care Entities* (2009) (product no. 012619kk [paperback], WHC-XXkk [online with the associated Audit Risk Alert], or DHC-XXkk [CD-ROM])
- Audit and Accounting Guide Government Auditing Standards and *Circular A-133 Audits* (2008) (product no. 012748kk [paperback], WRF-XXkk [online with the associated Audit Risk Alert], or DRF-XXkk [CD-ROM])
- Audit Guide *Analytical Procedures* (2008) (product no. 012558kk [paperback], WAN-XXkk [online], or DAN-XXkk [CD-ROM])

AICPA Audit and Accounting Manual  

AAM §8070.211
The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm’s needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to the AICPA’s latest Professional Standards, Technical Practice Aids, Audit and Accounting Guides, Audit Risk Alerts, Accounting Trends & Techniques, and more. To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

AICPA Audit Committee Toolkit for Government Entities

Taxpayers and citizens of governmental entities expect a government to be publicly accountable for the services it provides and for how it utilizes its resources to provide those services. An audit committee has the opportunity to assist the governing body with fiscal accountability demonstrated through strong internal controls, budgetary and other legal compliance, accurate and timely financial reporting, sound business practices, and a culture of strong moral and ethical behavior. More specifically, an audit committee with a government organization can help the government achieve the following:

- Improve financial practices and reporting. An audit committee can periodically meet with the government’s chief executive and financial officers to review, monitor, and direct activities and results related to the government’s maintenance of internal controls and preparation of financial reports.
• Enhance the internal audit function. When an internal audit team reports directly to the audit committee, the internal audit team can provide information to the audit committee about whether the government is meeting its financial and compliance responsibilities and recommend changes in practices and internal controls when necessary.

• Enhance the external audit function. An audit committee can meet with the external auditors to get independent observations about management’s efforts to maintain strong internal controls, appropriate financial reporting, and sound business practices.

.214 For governments interested in establishing or enhancing an audit committee, the AICPA Audit Committee Toolkit: Government Organizations (toolkit) provides valuable information and tools that will help a governing body and its officials create an effective audit committee function to help improve fiscal accountability.

.215 These tools inform and educate audit committees about changes in government reporting standards and the government environment as a whole. For governments that already have an audit committee, the toolkit may improve the efficiency and effectiveness of the audit committee. In either situation, the toolkit’s easy-to-use set of checklists, questionnaires, and other useful information can make the audit committee’s job easier to accomplish. The goal of the toolkit is to assist government audit committees in taking a much greater role in providing information to and assisting the governing body with meeting their fiduciary responsibilities. The audit committee tools are available for download from Audit Committee Effectiveness Center of the AICPA Web site at www.aicpa.org/Audcommctr/toolkitsgovt/homepage.htm.

Continuing Professional Education

.216 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs including the following:

• AICPA’s Annual Accounting and Auditing Update Workshop (2009–2010 Edition) (product no. 736185kk [text] or 187193kk [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.

• Internal Control Deficiencies: Assessment and Reporting Under SAS Nos. 112 & 115 (product no. 733292kk [text]). This course focuses on compliance with the standards’ requirements by examining each stage of the decision-making framework using numerous illustrations and practice exercises. The course also applies to managers of nonpublic companies to enable them to decide whether a control deficiency exists and how to correct it.

.217 Among the many courses, the following are specifically related to the state and local governments:

• State & Local Government Strategic Briefing—2008/2009 (product no. 780125kk [online]). This course, based on a webcast, provides participants with a strategic look at what’s important in the governmental accounting and auditing area. The program addresses recently issued GASB pronouncements affecting both preparers and auditors and features highlights of recently issued GAAS and the latest updates to the AICPA Audit and Accounting Guide State and Local Governments.

• Foundations in Governmental Accounting (product no. 731645kk [text]). This course features the fundamental tenets of governmental accounting and reporting in the post-GASB Statement No. 34 environment. Learn more than the buzz words—learn the underlying concepts and how they are applied.

• Governmental Accounting and Auditing Update (2008/2009 Edition) (product no. 736478kk [text] or 186484kk [DVD]). This timely, up-to-the-minute course is designed to provide you with a comprehensive understanding of new developments, so you can provide better services to both clients and the public. For 2008–2009, the course includes coverage of the new Yellow Book, the risk assessment SASs, SAS No. 112, and more.

• Government Accounting and Reporting: Putting It All Together (product no. 732803kk). This course goes deep into the accounting and reporting issues for state and local governments. Learn how to navigate
the complexities of government accounting and reporting in the post-GASB Statement No. 34 environment.

- *Audits of HUD-Assisted Projects* (product no. 730299kk). Gain in-depth, hands-on information regarding the HUD organization, programs, policies, and procedures. Review the professional standards affecting specific federal programs.

- *Frequent Frauds Found in Governments and Not-For-Profits* (product no. 733311kk [text]). Through an informative case study approach, this course illustrates common frauds that make headlines and damage the reputations of government and not-for-profits.

.218 Visit www.cpa2biz.com for a complete list of CPE courses.

**Online CPE**

.219 AICPA CPEExpress, offered exclusively through CPA2Biz, is the AICPA’s flagship online learning product. AICPA members pay $180 for a new subscription and $149 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPEExpress offers hundreds of hours of learning in a wide variety of topics. Some courses on state and local government topics include the following:

- *Government Accounting and Reporting: Preparing the Government-Wide Financial Statements*
- *Fraud in Exempt Organizations: The Governmental and Not-for-Profit Environments*
- *Yellow Book: Ethical Principles and General Standards*
- *2008 Annual Update: Government & NPO: GASB Activities*
- *Governmental and NPO Workpaper Techniques: Overall Approach*

.220 To register or learn more, visit www.cpa2biz.com.

**Webcasts**

.221 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession’s leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM or online.

**Member Service Center**

.222 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

**Hotlines**

**Accounting and Auditing Technical Hotline**

.223 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA’s Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/.

**Ethics Hotline**

.224 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA’s Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the
application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

Industry Conferences

.225 Governmental Accounting and Auditing Update Conference (GAAC) EAST is held in late summer in Washington, D.C., and its counterpart Governmental Accounting and Auditing Update Conference (GAAC) WEST takes place in Denver, Colorado in early fall. These conferences are designed for CPAs working in federal, state, and local government; public practitioners with government auditees; and regulators who need to be aware of emerging developments. These CPAs should attend this conference to remain current on the issues. Attending one of these conferences is a great way to receive timely guidance along with practical advice on how to handle new legislation and standards from key government officials and representatives of the accounting profession—including the standard setters themselves.

.226 AICPA National Governmental and Not-for-Profit Training is scheduled to be held in October in Atlanta, Georgia. Obtain the most up-to-date coverage on current and emerging issues and topics. Standard setters and industry leaders discuss a broad range of topics, including developments in governmental accounting and auditing, advances in financial statement reporting and the latest in proposed regulations, future issues affecting nonprofit organizations, and laws on the local, state, and federal government levels.

.227 AICPA National Health Care Industry Conference is scheduled to be held in September in Scottsdale, Arizona. This conference is an unparalleled opportunity to gain the information and techniques you need to know to stay on top of trends to benefit your practice and your client offerings. With access to some of the nation’s top health care specialists, you’ll get up-to-the-minute information on the latest developments in health care issues.

.228 For further information about the conferences, call (888) 777-7077 or visit www.cpa2biz.com.

AICPA GAQC

.229 The GAQC is a firm-based, voluntary membership center designed to improve the quality of governmental audits, and the value of such audits, to purchasers of governmental audit services. Governmental audits are audits and attestation engagements performed under Government Auditing Standards of federal, state, or local governments; not-for-profit organizations; and certain for-profit organizations, such as housing projects and colleges and universities that participate in governmental programs or receive governmental financial assistance. The GAQC keeps member firms informed about the latest developments, as well as provides tools and information to help them better manage their audit practice. Firms that join demonstrate their commitment to audit quality by agreeing to adhere to certain membership requirements.

.230 The GAQC has been in existence since September 2004. Since its launch, center membership has grown to almost 1200 firms from 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. The membership accounts for approximately 83 percent of the total federal expenditures covered in single audits performed by CPA firms in the Federal Audit Clearinghouse database (http://harvester.census.gov/sac/) for the year 2006 (the latest year with complete submission data).

.231 The center’s focus is to promote the highest quality audits and to save firms time by providing a centralized place to find information that they need, when they need it, to maximize quality and practice success. Center resources include the following:

- E-mail alerts with the latest audit and regulatory developments, including information on the ARRA and its impact on your audits
- Exclusive webcasts and teleconferences on compliance auditing and timely topics relevant to governmental and not-for-profit financial statement audits (optional CPE is available for a small fee, and events are archived online.)
• Dedicated GAQC Web site at www.aicpa.org/GAQC with resources, community, events, and products, and a complete listing of GAQC member firms in each state
• Online member discussion forums for sharing best practices and discussing issues firms are facing
• Savings on professional liability insurance

Help Desk—With all of the quality issues being noted in governmental audits (see further discussion in the “Legislative and Regulatory Developments” and “Audit and Attestation Issues and Developments” sections), your firm should consider joining the center. To enroll or learn more about the GAQC, including details on the membership requirements and fees for membership, go to www.aicpa.org/GAQC or e-mail GAQC staff at GAQC@aicpa.org. To preview member benefits, go to http://gaqc.aicpa.org/Memberships/.

AICPA Industry Expert Panel—State and Local Governments

.232 The State and Local Government Expert Panel is an AICPA volunteer group whose purpose it is to identify state and local government financial reporting and auditing issues and to work with appropriate bodies for resolutions benefiting the public interest; to conduct liaison activities with GASB regulators, such as the GAO and OMB, and applicable industry associations; and to advise and assist in the development of AICPA products and services related to state and local government audits. For information about the activities of the State and Local Government Expert Panel, visit the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_government.htm.

Industry Web Sites

.233 The Internet covers a vast amount of information that may be valuable to auditors of state and local governments, including current industry trends and developments. Some of the more relevant sites for auditors with governmental clients include those shown in the following table:

<table>
<thead>
<tr>
<th>Organization</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>Association of Governmental Accountants (AGA)</td>
<td><a href="http://www.agacgf.org">www.agacgf.org</a></td>
</tr>
<tr>
<td>Catalog of Federal Domestic Assistance (CFDA)</td>
<td><a href="http://www.cfda.gov">www.cfda.gov</a></td>
</tr>
<tr>
<td>Federal Audit Clearinghouse (FAC)</td>
<td><a href="http://harvester.census.gov/sac">http://harvester.census.gov/sac</a></td>
</tr>
<tr>
<td>Government Auditing Standards (Yellow Book)</td>
<td><a href="http://www.gao.gov/govaud/ybk01.htm">www.gao.gov/govaud/ybk01.htm</a></td>
</tr>
<tr>
<td>Governmental Accounting Standards Board (GASB)</td>
<td><a href="http://www.gasb.org">www.gasb.org</a></td>
</tr>
<tr>
<td>Financial Accounting Standards Board (FASB)</td>
<td><a href="http://www.fasb.org">www.fasb.org</a></td>
</tr>
<tr>
<td>Government Finance Officers Association (GFOA)</td>
<td><a href="http://www.gfoa.org">www.gfoa.org</a></td>
</tr>
<tr>
<td>National Association of Local Government Auditors (NALGA)</td>
<td><a href="http://www.governmentauditors.org">www.governmentauditors.org</a></td>
</tr>
</tbody>
</table>
The state and local government practices of some of the larger CPA firms also may contain industry-specific auditing and accounting information that is helpful to auditors.

This Audit Risk Alert replaces State and Local Governmental Developments—2008.

The Audit Risk Alert State and Local Governmental Developments is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year’s Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to ccole@aicpa.org or write to

Christopher Cole
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110
## Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

<table>
<thead>
<tr>
<th>Web Site Name</th>
<th>Content</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>AICPA</td>
<td>Summaries of recent auditing and other professional standards, as well as other AICPA activities</td>
<td><a href="http://www.aicpa.org">www.aicpa.org</a>&lt;br/&gt;www.cpa2biz.com&lt;br/&gt;www.ifrs.com</td>
</tr>
<tr>
<td>AICPA Accounting Standards Executive Committee</td>
<td>Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards</a></td>
</tr>
<tr>
<td>AICPA Accounting and Review Services Committee</td>
<td>Summaries of review and compilation standards and interpretations</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee</a></td>
</tr>
<tr>
<td>AICPA Professional Issues Task Force</td>
<td>Summaries of practice issues that appear to present concerns for practitioners and disseminate information or guidance, as appropriate, in the form of practice alerts</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force</a></td>
</tr>
<tr>
<td>Economy.com</td>
<td>Source for analyses, data, forecasts, and information on the U.S. and world economies</td>
<td><a href="http://www.economy.com">www.economy.com</a></td>
</tr>
<tr>
<td>The Federal Reserve Board</td>
<td>Source of key interest rates</td>
<td><a href="http://www.federalreserve.gov">www.federalreserve.gov</a></td>
</tr>
<tr>
<td>Financial Accounting Standards Board (FASB)</td>
<td>Summaries of recent accounting pronouncements and other FASB activities</td>
<td><a href="http://www.fasb.org">www.fasb.org</a></td>
</tr>
<tr>
<td>USA.gov</td>
<td>Portal through which all government agencies can be accessed</td>
<td><a href="http://www.usa.gov">www.usa.gov</a></td>
</tr>
<tr>
<td>Government Accountability Office</td>
<td>Policy and guidance materials and reports on federal agency major rules</td>
<td><a href="http://www.gao.gov">www.gao.gov</a></td>
</tr>
<tr>
<td>Governmental Accounting Standards Board (GASB)</td>
<td>Summaries of recent accounting pronouncements and other GASB activities</td>
<td><a href="http://www.gasb.org">www.gasb.org</a></td>
</tr>
<tr>
<td>International Accounting Standards Board</td>
<td>Summaries of International Financial Reporting Standards and International Accounting Standards</td>
<td><a href="http://www.iasb.org">www.iasb.org</a></td>
</tr>
<tr>
<td><strong>Web Site Name</strong></td>
<td><strong>Content</strong></td>
<td><strong>Web Site</strong></td>
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<tr>
<td>------------------</td>
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</tr>
<tr>
<td>International Auditing and Assurance Standards Board</td>
<td>Summaries of International Standards on Auditing</td>
<td><a href="http://www.iaasb.org">www.iaasb.org</a></td>
</tr>
<tr>
<td>International Federation of Accountants</td>
<td>Information on standards setting activities in the international arena</td>
<td><a href="http://www.ifac.org">www.ifac.org</a></td>
</tr>
<tr>
<td>Private Company Financial Reporting Committee</td>
<td>Information on the initiative to further improve FASB’s standard setting process to consider needs of private companies and their constituents of financial reporting</td>
<td><a href="http://www.pcfrr.org">www.pcfrr.org</a></td>
</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
<td>Information on accounting and auditing activities of the PCAOB and other matters</td>
<td><a href="http://www.pcaob.org">www.pcaob.org</a></td>
</tr>
</tbody>
</table>

[The next page is 8221.]
AAM Section 8080

Common Interest Realty Associations Industry Developments—2008

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of common interest realty associations with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also is intended to provide accountants with an update on recent practice issues and professional standards that may affect the compilation and review engagements they perform.

This publication is an other auditing publication as defined in AU section 150, Generally Accepted Auditing Standards (AICPA, Professional Standards, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards. If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate.

This publication is also an other compilation and review publication as defined in AR section 50, Standards for Accounting and Review Services (AICPA, Professional Standards, vol. 2). Other compilation and review publications have no authoritative status; however, they may help the accountant understand and apply the Statements on Standards for Accounting and Review Services. If an accountant applies the guidance included in an other compilation and review publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the engagement and appropriate.

The auditing and compilation and review guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Doug Bowman, CPA
Technical Manager
Accounting and Auditing Publications

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Monte Kane, CPA
Gary B. Rosen, CPA, CFE
Mark B. Shernicoff, CPA
Clifford J. Treese, CPCU, ARM, CIRMS
How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your audits of common interest realty associations (CIRAs). This alert also can be used by an entity’s internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool in helping you identify the significant risks that may result in the material misstatement of financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This alert is intended to be used in conjunction with the Comprehensive Audit Risk Alert—2008 (product no. 022339kk). Both alerts can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

Audit Risk

.03 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. In AU section 312, Audit Risk and Materiality in Conducting an Audit (AICPA, Professional Standards, vol. 1), audit risk is broadly defined as “the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated.” At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of (a) the risk (consisting of inherent risk and control risk) that the relevant assertions related to balances, classes, or disclosures contain misstatements (whether caused by error or fraud) that could be material to the financial statements when aggregated with misstatements in other relevant assertions related to balances, classes, or disclosures and (b) the risk (detection risk) that the auditor will not detect such misstatements.

.04 The auditor’s combined assessment of inherent risk and control risk is described as the risks of material misstatement. The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the risk assessment to determine the nature, timing, and extent of further audit procedures to be performed.

.05 As set forth in paragraph .12 of AU section 312, the auditor may reduce audit risk by determining overall responses and designing the nature, timing, and extent of further audit procedures. Furthermore, paragraph .19 of AU section 312 states that “[t]he auditor should seek to reduce audit risk at the individual balance, class, or disclosure level in such a way that will enable the auditor, at the completion of the audit, to express an opinion on the financial statements ... as a whole at an appropriately low level of audit risk.”

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.06 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor’s understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
• Measurement and review of the entity’s financial performance
• Internal control, which includes the five interrelated components identified in paragraph .41 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), and the selection and application of accounting policies, among other significant aspects of internal control relevant to the audit.

.07 The CIRA industry may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.08 The auditor should obtain an understanding of the entity’s objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity’s ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity’s business is also dynamic, and the entity’s strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.09 After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding. Paragraph .106 of AU section 314 states that, “[i]n making risk assessments, the auditor should identify the controls that are likely to prevent or detect and correct material misstatements in specific relevant assertions.” Specific internal control matters pertaining to CIRAs are discussed later in this alert.

.10 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client’s environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

**Economic and Industry Developments**

**The State of the Economy**

.11 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on the entity’s financial statements being audited.

.12 In September 2008, unprecedented events occurred in the financial markets, including the failure of a major investment bank, acquisitions of several investment and commercial banks (including some that required assistance from federal agencies), and the placement into conservatorship of the Federal National Mortgage Association (nicknamed Fannie Mae) and the Federal Home Mortgage Corporation (nicknamed Freddie Mac). Both Fannie Mae and Freddie Mac are government sponsored enterprises that purchase mortgages from lenders who originate them to either hold in their own portfolio or “securitize” them for sale in the secondary market. Further, several foreign financial institutions received assistance from their national governments or entered into similar acquisition agreements. Additionally, on September 17, 2008, a significant publicly-registered money market fund declined below the industry standard of $1.00 per share on a market value basis due to a combination of holdings of short-term securities issued by the failed investment bank and major shareholder redemptions. As a result of these events, the condition of the fixed income markets worsened, and corporations and financial institutions generally recognized as creditworthy
began experiencing difficulty borrowing money in the financial markets for any period of time longer than an overnight basis.

.13 In response, the U.S. Senate and, on October 3, 2008, the U.S. House of Representatives passed a bill, the Emergency Economic Stabilization Act of 2008 (the Act), which was signed into law by the president on that same day. Primary components of this bill include (a) an allocation of $700 billion to stabilize the U.S. financial system; (b) creation of an oversight board, executive compensation rules, and other corporate governance rules for any entities that participate; (c) increase of the statutory limit on public debt from $10.0 trillion to $11.3 trillion; (d) temporary increase of Federal Deposit Insurance Corporation (FDIC) insurance limits; (e) restatement of the Securities and Exchange Commission’s (SEC’s) authority to suspend the application of Financial Accounting Standards Board (FASB) Statement No. 157, *Fair Value Measurements*; and (f) the requirement of the SEC to conduct a study on the impact and effects of FASB Statement No. 157. The impact of these events on the financial markets in the coming months and years is difficult to predict.

.14 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.2 percent in 2007. According to 2008 third quarter preliminary estimates, real GDP decreased at an annual rate of 0.5 percent, which is down significantly from the 2.8 percent increase in real GDP during the second quarter of 2008.

.15 The unemployment rate remained relatively unchanged during 2007, holding between 4.4 percent and 5.0 percent, with an annual average rate of 4.6 percent. However, during 2008, the unemployment rate has risen. As of November 2008, the unemployment rate was 6.7 percent, representing approximately 10.3 million people.

.16 The target for the federal funds rate remained stable at 5.25 percent from June 2006 to September 2007 when the Federal Reserve began decreasing rates. Since the first rate decrease in September 2007, the Federal Reserve has decreased rates more than 5.0 percentage points to less than .25 percent as of mid December 2008. The Federal Reserve noted in its December press release that since October 2008, labor market conditions have deteriorated and the available data indicate that consumer spending, business investment, and industrial production have declined. Financial markets remain quite strained and credit conditions tight. Overall, the outlook for economic activity has weakened further. Inflationary pressures have diminished appreciably and are expected to continue to moderate. The Federal Open Market Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time.

**Industry Trends and Conditions**

*Current Economic Downturn*

.17 Since early 2007, the decline in the residential housing market has sent shockwaves through the entire U.S. economy. The affected parties from the housing market downturn range from homeowners to investment banks to investors in real estate companies. The outlook regarding whether we have hit the bottom yet is not consistent among analysts and experts. However, the overwhelming sentiment is that a further decline is likely. According to the *New York Times*, from 2001 to 2007 domestic financial indebtedness grew from $8.5 trillion to $14.5 trillion, with home mortgage debt responsible for $5.1 billion (or 85 percent) of that change (home mortgage debt increased from $4.9 trillion to $10 trillion). In 2007, the total indebtedness was three times the size of the GDP. This type of scenario has not occurred since the Great Depression. This current situation has arisen from what some experts have described as the perfect storm of circumstances, which include rising home values, historically low interest rates, the loosening of underwriting and lending standards, unprecedented high loan-to-value ratios, and the notion that housing is a fail-safe investment.
The combination of the state of the economy, the failures of and subsequent takeovers of banks, and the actions taken by the U.S. Treasury during 2007 and 2008 are unprecedented. Some of the possible effects on real estate and construction companies include counterparty default risk, concentration on liquidity, shrinking balance sheets due to asset write-downs, contraction of credit availability, increased focus on recourse versus nonrecourse debt, tenant defaults leading to greater allowances for doubtful accounts and write-offs, and a general lack of opportunity for activity and investment in the market place.

The real estate residential market has continued to experience challenging times, with most experts not anticipating a turnaround in the near future. According to the National Association of Realtors (NAR), from May to June 2008 existing home sales fell 2.6 percent and, when compared to June 2007, decreased 15.5 percent. As of the first week in August 2008, mortgage applications decreased 8.1 percent from a month prior and 29.5 percent from the prior year. June 2008 median housing prices also dropped 10 percent when compared to June 2007. Construction starts of buildings with two units or more (for sale, not for rent) during the first two quarters of 2008, compared with construction starts in the first two quarters of 2007, 2006, and 2005, declined 32 percent, 51 percent, and 39 percent, respectively.

Option adjustable rate mortgages (ARMs) became popular during the peak of the residential real estate cycle. The defining characteristics of an option ARM include the ability in the beginning to make minimum payments that do not cover any principal and do not necessarily cover all the interest. Any unpaid interest is added to the loan balance up to a certain dollar threshold. At that point the loan is recast (that is, recalculated) as a standard amortizing principal loan. The interest rates usually increase to typical mortgage rates after the first few months. According to Credit Suisse, by April 2009 monthly option recasts will reach $5 billion and peak around January 2010 with $10 billion in recasts. Of the option ARMs issued in 2006, approximately 13 percent were 60 days delinquent within the first 18 months of issuance. As of June 2008, borrowers with option ARMs number about 1 million. As of mid-2008, only a small amount have been recast, which explains the overwhelming estimates for recasting in 2009 and 2010. Additionally, of the approximately $500 billion of outstanding option ARM loans as of June 2008, 60 percent are attributable to California homeowners.

According to RealtyTrac, foreclosure filings in June 2008 were down 3 percent from May 2008, but up 53 percent from June 2007 for a total of 252,363 properties for the month of June 2008. This is equivalent to 1 out of every 483 U.S. households. However the actual locales of these properties receiving foreclosure filings are highly concentrated in Nevada, with 1 out of every 122 households in foreclosure; in California, with 1 out of every 192 households in foreclosure; and in Arizona, with 1 out of every 201 households in foreclosure. Regions with the fastest and greatest growth during the real estate boom also have fallen the fastest and hardest during this downturn. Many mortgages in trouble are associated with homes located in affordable outskirts of expensive cities.

The causes of the residential real estate downturn are numerous, with the result being larger than the sum of its pieces due to their unique interaction. Speaking about the general real estate market, a PricewaterhouseCoopers June 2008 Global Real Estate Now article noted, “The velocity and froth that accompanied the rush to ‘do deals’ created a highly competitive environment that led both issuers and investors to act in favour of the greater greed rather than the greater good.” With rising real estate values, historically low interest rates, and abundant sources of liquidity, both banks and borrowers entered into riskier than normal mortgages. These mortgages had little to zero money down, high loan-to-value ratios, teaser interest rates, and decreased to nearly nonexistent scrutiny of income verification. Essentially, many borrowers received mortgages they could not really afford and banks took on the additional risk.

As delinquencies began increasing in the residential market, lenders were unable to sell the loans they had already made. In addition, the secondary market dried up due to executives being nervous about the quality of the assets, the riskiness of these investments, and the soundness of the financial institutions. This inhibited banks from being able to sell loans for securitizations, which reduced liquidity and lending activity even further. This is further exacerbated by defaulting homeowners and imminent foreclosures of homes that may not be worth the outstanding loan value. According to a Real Estate Research Corporation survey of investors, the following information was gathered on the availability of capital (on a scale of 1 to 10, with
10 being the highest): 8.7 in the first quarter of 2007, 5.5 in the fourth quarter of 2007, and 4.7 in the first quarter of 2008.

.24 The multifamily housing rental market also has been negatively affected by the residential real estate conditions. According to NAR, vacancy rates are expected to rise to 5.7 percent by the end of 2008, up from 4.8 percent at the end of 2007. An explanation for this trend is that the second half of 2008 will produce an increase in first time home buyers due to declining prices and the recently implemented tax credit for first time home buyers. According to CB Richard Ellis, other factors shifting vacancy upward include job losses and an increase in supply. However, the increase in supply is not only from completed construction of for-rent buildings, but also from previously for-sale condominium units being made available to rent. This phenomenon is only expected to increase as more condominium buildings are completed without a matching increase of demand to buy.

Going Green and Value Engineering

.25 As CIRAs across the country are faced with ongoing increases in the cost of maintenance, energy, and major repairs and replacements, more and more are looking for ways to minimize the effect on monthly assessments. Many CIRAs analyze their budget by examining costs of maintenance, energy, and major repairs and replacements individually. However, an increasingly prevalent approach is being utilized in some areas of the country in which CIRAs are performing a consolidated analysis of all three portions of the budget to take advantage of the cost savings that can be realized as a result of understanding the relationships among all three portions. One way CIRAs are saving money is through green initiatives, specifically through a CIRA's reduced energy consumption as well as the use of alternative energy sources.

.26 Typically, the replacement of a wood deck, for example, is done by installing material and equipment similar to the original components. However, by using an integrated approach referred to as value engineering, the CIRA can perform a comprehensive material and equipment review that includes all associated energy, maintenance, and replacement costs. This analysis may suggest using a different type of material, such as composite decking, which does not require replacement or ongoing maintenance. Although the initial cost of the maintenance-free material might be higher, a net savings is achieved through lower maintenance costs and an extended life span. CIRAs using this approach are in a position to evaluate different options for material and equipment upgrades that often may result in long-term reductions in overall costs for these three budget areas in the aggregate. The auditor should be aware certain replacements may constitute capital improvements that involve other considerations, such as member approval, among other important considerations.

Residential Community Association Demographics

.27 It is estimated that 85 percent to 90 percent of all new for-sale housing is located in one of the three basic types of CIRAs. Between 40 percent and 60 percent of CIRAs are contract managed by specialized community association management companies and the remaining CIRAs are self-managed either solely by volunteers or with association-hired staff. Regardless of management structure, all CIRAs are governed by a volunteer board of directors elected by the membership. Housing cooperative corporations represent approximately 5 percent to 7 percent of all association units. Condominium associations represent 38 percent to 42 percent and planned communities constitute the balance. Despite the continuing growth of CIRA residents, as noted in the following table, this distribution has remained constant over the past few years.

Quick Facts About Residential Community Associations

.28 The following table presents quick facts about residential community associations:
2004 2005 2006 2007 2008

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of CIRAs</td>
<td>260,000</td>
<td>273,600</td>
<td>286,000</td>
<td>295,700</td>
<td>300,800</td>
</tr>
<tr>
<td>No. of CIRA housing units</td>
<td>20,800,000</td>
<td>22,160,000</td>
<td>23,100,000</td>
<td>23,800,000</td>
<td>24,100,000</td>
</tr>
<tr>
<td>CIRA residents</td>
<td>51,800,000</td>
<td>54,600,000</td>
<td>57,000,000</td>
<td>58,800,000</td>
<td>59,500,000</td>
</tr>
<tr>
<td>U.S. population</td>
<td>293,200,000</td>
<td>295,900,000</td>
<td>298,800,000</td>
<td>301,600,000</td>
<td>305,400,000</td>
</tr>
</tbody>
</table>

.29 To further put the size of the CIRA industry in perspective, consider that CIRA boards of directors supervise the collection of over $41 billion in annual assessments. For comparison purposes, less than 5 percent of manufacturing industries reported total shipments to customers that exceeded $41 billion, according to the most recent data available on the Bureau of Economic Analysis Web site at www.bea.gov.

Legislative and Regulatory Developments

Select State Developments

.30 States are increasingly imposing financial reporting requirements that include specific information to be presented or disclosed in a CIRA’s financial statements, and such information may be in addition to that required by generally accepted accounting principles (GAAP). For example, in May 2008, Florida passed amendments to Chapter 718, Condominiums, of the Florida Statutes that, among other significant provisions, state that financial statement disclosures must include “at least a summary of the reserves [for future major repairs and replacements], including information as to whether such reserves are being funded at a level sufficient to prevent the need for a special assessment and, if not, the amount of assessments necessary to bring the reserves up to the level necessary to avoid a special assessment.” Also included in the amendments to Chapter 718 were restrictions on the ability of a CIRA to waive certain financial reporting requirements imposed in Chapter 718. The auditor should consider these statutory requirements when auditing a CIRA’s financial statements in addition to the GAAP requirements.

Taxation Developments

80/20 Rule for Cooperative Housing Corporations

.31 The Mortgage Forgiveness Debt Relief Act of 2007 was enacted in December 2007. This act amends subparagraph (D) of section 216(b)(1) of the Internal Revenue Code (IRC) of 1986, which defines cooperative housing corporations. Under IRC section 216 (b)(1), a tenant-stockholder in a cooperative corporation is entitled to deduct his or her proportionate share of the cooperative corporation’s real estate taxes and mortgage interest. Under previous law, this deduction was only available if the cooperative corporation met the 80/20 rule. The 80/20 rule required that 80 percent or more of the cooperative corporation’s revenue must come from the tenant-stockholders.

.32 Under the new legislation, two alternative tests are added to the previous 80 percent test. In order to qualify as a cooperative corporation, only one of the following three tests has to be met:

1. “Eighty percent or more of the [cooperative] corporation’s gross income ... is derived from tenant-stockholders.

2. At all times during [the] year, 80 percent or more of the total square footage of the [cooperative] corporation’s property is used or available for use by the tenant-stockholders for residential purposes or purposes ancillary to such residential use.
Ninety percent or more of the expenditures of the [cooperative] corporation paid or incurred during [the] year are paid or incurred for the acquisition, construction, management, maintenance, or care of the [cooperative] corporation’s property for the benefit the tenant-stockholders.”

Many cooperative corporations that previously struggled to meet the 80/20 rule will be able to meet one of the preceding tests.


Previous regulations required all cooperative corporations, excluding farmers’ cooperatives, to file their income tax returns on Form 1120, “U.S. Corporation Income Tax Return.” Because Form 1120 did not distinguish between Subchapter T cooperatives that meet the requirements of IRC section 6072(d) prior to filing and thus must file by the 15th day of the 3rd month after the end of the tax year and those that do not meet the requirements and thus must file by the 15th day of the 9th month after the end of the tax year, the IRS had difficulty determining which filing deadline applies and deciding whether to assert delinquency and failure to pay penalties in the case of returns filed after the 2½ month deadline.

Final regulations, effective for taxable years ending on or after December 21, 2007, require all cooperative corporations to which Subchapter T applies (Subchapter T cooperatives) to file their returns on Form 1120-C, “U.S. Income Tax Return for Cooperative Associations.” The information that Subchapter T cooperatives will be required to provide on the new Form 1120-C will assist taxpayers and the IRS in determining the appropriate filing deadline. Having that information will reduce the burden on taxpayers and help the IRS avoid asserting penalties in inappropriate cases. Having all Subchapter T cooperatives file their income tax returns on Form 1120-C also will eliminate confusion over which form to file and promote efficiency in addressing income tax issues common to Subchapter T cooperatives.

A significant difference from Form 1120 is the addition of Schedule G that specifically requires the allocation of all income and expense items into patronage and nonpatronage columns for all cooperative corporations with over $250,000 in gross receipts. Previously, such an allocation was only explicitly required for cooperative corporations reporting over $10 million in gross receipts. This allocation always has been required for all cooperative corporations but not physically displayed on Form 1120.

One result of allocating income on Schedule G is that net operating losses stay segregated by patronage and nonpatronage sources. The IRS rules prevent patronage losses from offsetting nonpatronage income. This can result in some pitfalls as a cooperative corporation uses up a net operating loss. In loss years, the loss is normally not allocated to members, resulting in an accumulation of patronage and nonpatronage net operating losses. When the cooperative corporation begins generating a positive net income, it may issue patronage dividends before its patronage net operating loss is used. This can result in a situation where it will not be able to use up its patronage net operating loss and will pay more tax on its nonpatronage income than would be expected by only looking at the overall net operating loss carry-forward.

Special Tax Issue Related to Mixed-Use Projects

The residential real estate industry continues to see the development of numerous mixed-use projects, which contain space for both residential and commercial use. Many of these mixed-use projects contain for-sale units and therefore have a CIRA. To qualify to file Form 1120-H, “U.S. Income Tax Return for Homeowners Associations,” and take advantage of the income tax benefits provided under IRC section 528, “Certain Homeowners Associations,” the CIRA must qualify as a homeowners association, which includes a “substantiality test” prescribed in U.S. Treasury Regulation § 1.528-4. This regulation states in part that, “[i]n order for an organization to be considered a condominium management association or a residential real estate management association (and therefore in order for it to be considered a homeowners association), substantially all of its units, lots or buildings must be used by individuals for residences.” Readers may refer to the TaxAlmanac Web site at www.taxalmanac.org for further guidance.
Other Legislation

.39 In light of the fact that cash and cash equivalents are normally material to a CIRA’s balance sheet, the auditor should be aware that, as part of the previously mentioned Emergency Economic Stabilization Act of 2008, the amount of deposit insurance provided by the FDIC is increased from $100,000 to $250,000, effective as of the date of enactment of the bill (October 3, 2008). This provision remains in effect until December 31, 2009. FDIC insurance covers funds in deposit accounts, including checking and savings accounts, money market deposit accounts, and certificates of deposit. FDIC insurance does not, however, cover other financial products and services that insured banks may offer, such as stocks, bonds, mutual fund shares, life insurance policies, annuities, or municipal securities.

.40 As part of its cash and cash equivalents, a CIRA may have a significant amount of money market holdings. Further protecting a CIRA’s money market funds is the U.S. Treasury Department’s Temporary Guarantee Program for Money Market Funds. Under this program, the U.S. Treasury guarantees the share price of participating money market funds that seek to maintain a stable net asset value of $1.00 per share, subject to certain conditions and limitations, for amounts held in participating money market funds as of the close of business on September 19, 2008. Eligible funds must be regulated under Rule 2a-7 of the Investment Company Act of 1940, must maintain a stable share price of $1.00, and must be publicly offered and registered with the SEC. Both taxable and nontaxable funds are eligible for this program. To participate in the program, eligible funds must pay a fee and complete a guarantee agreement and related documents. President George W. Bush approved the use of existing authorities by U.S. Treasury Secretary Henry M. Paulson, Jr., to make available as necessary the assets of the Exchange Stabilization Fund to support the program.

.41 The program will be in effect for an initial three month term, after which the U.S. Treasury Secretary will review the need and terms for the program and the costs to provide the coverage. The secretary has the option to extend the program up to the close of business on September 18, 2009. In order to maintain coverage, funds would have to renew their participation in the program after each extension. If the secretary chooses not to extend the program at the end of the initial three month period, the program will terminate.

Uniform Common Interest Ownership Act

.42 The Uniform Common Interest Ownership Act (UCIOA) was amended in order to update the 1994 UCIOA, which provides provisions for creating, managing, and terminating condominium, planned community, and other types of real estate cooperative corporations. Uniform acts become laws only to the extent that they are enacted into law by state legislatures. State legislatures do not have to enact the precise language of a uniform act and often enact laws with at least some modifications. See the full text of the amendments at www.law.upenn.edu/bll/archives/ulc/ucioa_bor/2008am_approved.pdf.

Audit and Attestation Issues and Developments

Audit Risks Arising From Current Economic Conditions

.43 As mentioned in “The State of the Economy,” unprecedented events occurred in the financial markets in September 2008, resulting in Congress appropriating up to $700 billion to purchase various asset-backed securities. Generally, many fixed income markets became extraordinarily illiquid in late September 2008, resulting in a substantial increase in risk over the valuation assertion for virtually any kind of fixed income security, of any duration. Also, concerns existed about the possibility of significant redemptions from various types of funds and some reports of certain private funds either placing limits on redemptions, freezing the ability to redeem entirely, or determining to commence an orderly wind-down of operations. Thus, subsequent events reporting considerations, and assessment of the “going concern” status of some entities, take on added importance in the current environment as well.

.44 The AICPA staff has issued Technical Questions and Answers (TIS) section 1100.15, “Liquidity Restrictions” (AICPA, Technical Practice Aids), addressing the potential accounting and auditing implications
when a fund or its trustee imposes restrictions on a nongovernmental entity’s ability to withdraw its balance in a money market fund or other short term investment vehicle. The question and answer covers balance sheet classification, disclosures, debt covenants, subsequent events, and going concern considerations, among other things, and can be found at www.aicpa.org/download/acctstd/TIS1100_15.pdf.

.45 Recent economic conditions may cause additional risk factors that had not existed or did not have a material effect on audit clients in prior years. When obtaining an understanding of the external factors that affect the entity and the risks associated with those factors, the auditor may consider whether conditions exist that indicate risks of material misstatement. Some examples that relate to economic conditions are as follows:

- CIRA activities that are exposed to rising prices of key inputs, including energy, insurance, and construction costs
- Constraints on the availability of capital and credit
- CIRAs in regions with economic volatility, including employment and housing issues related to oversupply and significantly depressed valuations
- Going concern and liquidity issues
- Increasing level of delinquent assessments and bad debts
- Changing mix of unit owners caused by longer presale holding periods of developer-owned units, which may create a concentration of credit risk for the CIRA
- Increasing move toward debt financing, which is possible in an increasingly tightening credit market, to fund future repairs and replacements, rather than special assessments or aggressive funding plans

.46 Although many of these risks are not new to business, consideration of the many ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks.

Delinquent Assessments and Bad Debts

.47 Falling property values, lender foreclosures, adverse economic conditions, and homeowner bankruptcies create a tumultuous operating environment for CIRAs. These factors have led to a sharp increase in the number of homeowners who are behind in paying their association assessments. In turn, delinquencies result in a shortfall in the CIRA’s annual revenue and the cost of operating the CIRA must be spread among the other owners who are paying their assessments.

.48 As a result of the rising delinquencies, the CIRA’s balance sheet may reflect an inadequate reserve for bad debts and receivables for assessments that have aged more than in past years. If provided for by the CIRA’s governing documents or state statute, the CIRA also may have recorded receivables for the assessment of interest, late fees, collection costs, and attorney fees. The net realizable value of a CIRA’s accounts receivable balance is an accounting estimate, the reasonableness of which the auditor is responsible for evaluating in the context of the financial statements taken as a whole. Paragraph .10 of AU section 342, Auditing Accounting Estimates (AICPA, Professional Standards, vol. 1), states that, “[i]n evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate.”

.49 If the auditor believes the estimated amount included in the financial statements is unreasonable, based on the auditor’s review and testing of management’s process to develop the estimate, the auditor’s independently developed estimate, the auditor’s review of events or transactions occurring subsequent to the date of the balance sheet but prior to the date of the auditor’s report, and other procedures performed, he or she should treat the difference between that estimate and the closest reasonable estimate as a likely misstatement. AU section 312 establishes requirements for and provides guidance on the auditor’s responsibilities for known and likely misstatements.
Adverse economic conditions may create pressures on CIRAs to compromise the adequacy of the presentation of the required supplementary information (RSI) on future major repairs and replacements. For example, a CIRA already experiencing difficulties in collecting member assessments may be hesitant to update its cost study (hereinafter referred to as reserve study) if it suspects that an updated version might increase the recommended level of funding. Although paragraph .04 of AU section 558, Required Supplementary Information (AICPA, Professional Standards, vol. 1), states that “[t]he auditor has no responsibility to audit information outside the basic financial statements in accordance with generally accepted auditing standards,” the auditor should apply certain limited procedures to RSI and report deficiencies in, or the omission of, such information. These limited procedures ordinarily should include inquiries of management about the methods of preparing RSI, including any significant assumptions or interpretations underlying the measurement or presentation.

Based on these limited procedures performed, auditors may find that the estimates of current or future costs of major repairs and replacements presented as RSI have not been recently updated to adequately reflect the trend of rising construction costs. Paragraph 4.33 of the AICPA Audit and Accounting Guide, Common Interest Realty Associations (the CIRA guide), states that CIRAs should present “[e]stimates of current or future costs of future major repairs and replacements of all existing components.” Outdated reserve studies on which these estimates are based may create substantial doubts about whether RSI conforms to the requirements in the CIRA guide. A complete description of recommended practices for the preparation of a reserve study can be found in the publication “National Reserve Study Standards of the Community Associations Institute” published by the Community Associations Institute (CAI), a multidisciplinary, nonprofit organization serving all stakeholders in community associations for more than 35 years. Readers may refer to the CAI Web site at www.CAIonline.org.

Another factor that may indicate RSI is not measured or presented within guidelines established by the aforementioned National Reserve Study Standards is whether the sources or studies used in the preparation of the estimates of current or future major repairs or replacements were prepared by a reserve specialist, a certification offered by the CAI, or other certified professional, such as an engineer or architect. Although such level of expertise in developing reserve studies is not required by the CIRA guide, it may be required by statute, as it is for certain condominium associations in Florida, and it is a factor to consider when performing the limited procedures required to be applied to RSI as part of a CIRA audit engagement.

When the auditor is unable to resolve these aforementioned substantial doubts, paragraph .08 of AU section 558 explains that the auditor should add an explanatory paragraph to the report on the audited financial statements. However, because RSI is outside the basic financial statements, these circumstances do not affect the auditor’s opinion on the fairness of presentation of such financial statements in conformity with GAAP.

Funding for Future Major Repairs and Replacements

As part of understanding the entity and its environment, the auditor should be knowledgeable of the funding plan applicable to the CIRA and whether it is imposed by the CIRA’s governing documents, a statutory obligation, or other binding requirement, such as a board resolution. The CAI publishes the “National Reserve Study Standards of Community Associations Institute,” which recognizes four types of funding plans—full funding, baseline funding, threshold funding, and statutory funding. All four funding plans are based on the following:

- Component inventory (that is, the list of all physical components of common property) that the CIRA must eventually replace or for which major repair obligations will be incurred
- Repair or replacement costs (either current costs or future costs)
- Remaining useful life until replacement or repair
55 The full funding plan is the most conservative in that it will generate more accumulated funds and the baseline funding plan is the least conservative in that its strategy is to simply keep the accumulated funds above zero. Refer to the “National Reserve Study Standards of Community Associations Institute” for more information on the characteristics and strategies of each type of plan. Note that the use of special assessments and loans also may be a part of a CIRA’s funding plan. A sufficient understanding of the CIRA’s funding policy is necessary for the auditor to evaluate the CIRA’s note disclosures for compliance with the funding policy and for adequacy, including the bases of amounts set forth in the notes, as explained in AU section 431, Adequacy of Disclosure in Financial Statements (AICPA, Professional Standards, vol. 1). See the section of this alert entitled “Certain Note Disclosures.”

56 Adverse economic conditions also may affect the CIRA’s ability to comply with existing funding policies or statutory funding requirements for future major repairs and replacements. Paragraph 4.27 of the CIRA guide states that disclosures about such funding should include, among other items, a description of the CIRA’s funding policy and compliance with that policy. The CIRA guide also states that any special assessments or borrowings to fund major repairs and replacements should be disclosed, including any assessments used for purposes other than those for which they were designated. Additionally, paragraph 4.33 of the CIRA guide states that RSI should include the amount of funds accumulated for each component included in the estimates of current or future major repairs and replacements to the extent designated by the board. If the disclosure about a CIRA’s funding for major repairs and replacements is absent or inadequate, AU section 508, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1), establishes requirements and provides applicable guidance. If the CIRA elects to only partially adopt the funding requirements set forth in the reserve study, or if the CIRA elects to defer all funding of the reserve for future major repairs and replacements, the auditor may refer to the example disclosures presented in the CIRA guide.

Certain Concerns at Inception of the CIRA

57 Generally, when a developer or builder, or both, plans a CIRA, whether it is new construction or a conversion, governing documents are prepared for the CIRA, including the type of CIRA, descriptions of the community, and the initial operating budget, which also may contain the initial reserve study. An engineer’s report and a detailed public offering statement also may be included in the governing documents. These governing documents also include a description of the common elements, which will be the responsibility of the CIRA to maintain and replace, as opposed to those components that are the responsibility of the individual unit owners. At this stage, a number of concerns exist relevant to the audit.

58 When the governing documents are prepared for new construction, in many cases the construction has not yet been completed or even commenced. As is typical with most construction, field changes may occur, such that the as-built community does not match the design drawings. The reserve study may be based on the design drawings so it too may no longer match the as-built community. This may result in underfunding of the future major repairs and replacements. To minimize this concern, it is recommended that the developer or the CIRA have the original reserve study included within the governing documents updated to reflect the as-built community. The replacement costs also should be updated. The auditor is reminded that new construction typically carries certain warranties (statutory and other) that may affect the reserve study.

59 In the situation in which the newly formed CIRA is a conversion from another use and not a newly constructed community, another concern arises. This concern is the fact that the components that constitute the common elements are not new and have reduced useful lives. Although with both new construction and conversions the beginning balance in the reserve account is $0, in the case of the conversion and the reduced useful lives, the replacement costs must be amortized over this reduced life, which subsequently will result in higher annual contributions. A risk exists that the reduced useful lives would not be properly accounted for in the reserve study, resulting in unanticipated replacements and inadequate funds at the time of these replacements. Thus, when a newly formed CIRA is the result of a conversion from another use, the auditor might include additional inquiries of management to help ascertain the reasonableness of the methods used to prepare the RSI.
Auditors are reminded that the interests of the developer and the interests of the future unit owners, as they pertain to the reserve study and funding plan, may be divergent. At the time of the preparation of the initial reserve study and development of the policies related to the funding plan, the developer is still in control. The developer’s objectives may be to keep the assessments as low as possible to induce sales, which may not provide for adequate accumulation of funds for future major repairs and replacements.

**Concentration of Revenue**

The combination of the effects of the current economic downturn and the ongoing housing contraction is slowing the rate at which developers of common interest communities are able to sell new units. Thus, the extended developer holding period may be exposing the CIRA to a greater risk of loss than would otherwise exist if the units were owned by individuals. This concentration of revenue has the potential to severely affect the CIRA’s financial condition in the event the developer encounters a financial hardship or is otherwise unable or unwilling to pay assessments or other amounts owed to the CIRA in accordance with the CIRA’s governing documents and state statutes. Paragraph 4.25 of the guide states that, “[i]f 10 percent or more of a CIRA’s revenues are derived from any one source, [including revenues from a developer,] that fact and the amount of revenue from each source [providing 10 percent or more of the revenue] should be disclosed.”

Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (AICPA, Technical Practice Aids, ACC sec. 10,640), requires additional disclosures related to the concentration of revenue if all of the following criteria are met, based on information known to management prior to issuance of the financial statements:

- The concentration exists at the date of the financial statements.
- The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.
- It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

Disclosure of concentrations meeting the aforementioned criteria should include information that is adequate to inform users of the general nature of the risk associated with the concentration.

**Going Concern**

In a severe economic downturn, more than a nominal number of CIRAs may find themselves unable to meet their financial obligations, particularly those that have outstanding debt. With foreclosures of CIRA units on the rise, so are delinquent CIRA assessments. These conditions, among other factors, are contributing to many CIRAs being cash strapped. Although CIRA bankruptcies or financial collapses have not been very common historically, the negative effects of the previously discussed economic circumstances are creating unprecedented financial troubles for CIRAs. Paragraph .02 of AU section 341, *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern* (AICPA, Professional Standards, vol. 1), states that “[t]he auditor has a responsibility to evaluate whether there is substantial doubt about the [CIRA’s] ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.” The following conditions and events may be good indicators of a CIRA’s questionable continuation prospects:

- Negative trends, such as recurring operating losses, working capital deficiencies, and negative cash flows from operating activities
- Internal matters, such as excessively strained relations between the homeowners and the CIRA’s board of directors
- External matters, such as pending litigation, an uninsured or underinsured catastrophe, or the developer’s default on amounts owed to the CIRA
• Other indications of financial difficulties, such as noncompliance with debt covenants, delays in payments to suppliers, and the placement of the CIRA in receivership wherein a court-appointed receiver manages the affairs of the CIRA.

.65 If, after considering the board of director’s plans to address the adverse effects of the conditions and events, the auditor concludes that substantial doubt about the CIRA’s ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph to reflect that conclusion. Also, the auditor should comply with the communication requirements established in paragraph .17 of AU section 341.

Auditing Fair Value Measurements

.66 A CIRA may have diverse investment holdings and other assets, liabilities, and components of equity that may be subject to measurement or disclosure at fair value in the financial statements. It is management’s responsibility to make the fair value measurements and disclosures. When auditing these fair values to ensure they are in conformity with GAAP, auditors should consult AU section 328, Auditing Fair Value Measurements and Disclosures (AICPA, Professional Standards, vol. 1), which establishes standards and provides guidance for auditors. Certain specific types of fair value measurements are not covered by AU section 328. For example, when auditing the fair value of derivatives and securities, refer to AU section 332, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities (AICPA, Professional Standards, vol. 1).

.67 The strongest audit evidence to support a fair value is an observable market price in an active market. If that is not available, a valuation method should incorporate common market assumptions. If common market assumptions are not available or require significant adjustments, the entity may use its own assumptions. The auditor should obtain an understanding of the entity’s process for determining fair values, as well as whether the fair value measurements and disclosures are in accordance with GAAP. During this testing, the auditor also may identify any possible indicators of impairment. According to paragraph .23 of AU section 328, “[S]ubstantial tests of the fair value measurements may involve (a) testing management’s significant assumptions, the valuation model, and the underlying data, (b) developing independent fair value estimates for corroborative purposes, or (c) reviewing subsequent events and transactions.”

.68 According to paragraph .48 of AU section 328, the auditor ordinarily should add language to the letter of representations from management regarding the reasonableness of significant underlying assumptions. When significant assumptions are used or they are highly subjective, and the items being measured at fair value are material, the auditor considers discussing these items with those charged with governance of the entity.

Fair Values of Securities

.69 The guidance in AU section 332 relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, some items of note exist for the auditor. As noted previously, quoted market prices in active markets are the best available audit evidence to support a fair value. However, when they are unavailable and the valuations of securities are obtained from a broker-dealer or another third party source based on valuation models, the auditor should understand the underlying valuation method used (such as a cash flow projection). The auditor also may determine it is necessary to obtain quotes from more than one pricing source based on circumstances such as an existing relationship between the entity and the valuing entity, which could inhibit objective pricing or underlying valuation assumptions that are highly subjective. In the context of FASB Statement No. 157, quoted prices in active markets are considered Level 1 inputs.

.70 When an entity performs its own valuation, value testing procedures to be taken by the auditor include assessing the reasonableness and appropriateness of the model, calculating the value using his or her own model, and comparing the fair value with subsequent or recent transactions. Whether the inputs to the entities’ valuation model are observable or not determines their characterization as Level 2 or Level
The auditor also should evaluate management’s conclusions regarding other than temporary impairment on its securities. Examples of factors that could cause an other than temporary impairment per paragraph .47 of AU section 332 include the following:

- “Fair value is significantly below cost and
  — the decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
  — the decline has existed for an extended period of time.
  — management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
- The security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
- The entity recorded losses from the security subsequent to the end of the reporting period.”

Additional factors to consider when determining whether a security is other than temporarily impaired, as described in the September 30, 2008 press release by the SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting (SEC and FASB press release), include “[the] the length of the time and the extent to which the market value has been less than cost; [t]he financial condition ... of the issuer; or [t]he intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.” The classification of an entity’s securities is based on management’s intent and ability. The auditor should obtain an understanding of management’s classification process among trading, available-for-sale, or held-to maturity, as well as consider the classifications in light of the entity’s current financial position.

**Pending Litigation**

Although not an emerging type of risk, pending litigation is frequently a major consideration in a CIRA audit. FASB Statement No. 5, *Accounting for Contingencies*, specifically states that pending litigation is an example of a loss contingency. However, absent meeting the conditions for accrual of the loss set forth in paragraph 8 of FASB Statement No. 5, namely that it is probable that a liability had been incurred at the date of the financial statements and the loss is reasonably estimable, the pending litigation should be disclosed rather than accrued. The disclosure should indicate the nature of the contingency and give an estimate of the possible loss or range of loss or state that such an estimate cannot be made.

SOP 94-6, establishes requirements and provides guidance on additional disclosures that may be required for certain significant risks and uncertainties, to the extent that the requirements of SOP 94-6 are not already met by the disclosures required by other pronouncements. The areas of significant risks and uncertainties addressed by SOP 94-6 include the nature of operations, the use of estimates in the preparation of financial statements, certain significant estimates, and current vulnerability due to certain concentrations. An estimate that does not involve a contingency covered by FASB Statement No. 5, such as estimates associated with long-term operating assets and amounts reported under profitable long-term contracts, may still meet the criteria for disclosure set forth in paragraph .13 of SOP 94-6.

SOP 94-6 states that the disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term. If the estimate involves a loss contingency covered by FASB Statement No. 5, the disclosure also should
include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Disclosure of the factors that cause the estimate to be sensitive to change is encouraged but not required.

.76 Using the same preceding example relating to pending litigation, if this same pending litigation met the criteria for disclosure set forth in SOP 94-6, the CIRA would include an additional disclosure to indicate “that it is at least reasonably possible that a change in the company’s estimate of its probable liability could occur in the near term.” Disclosure of the factors that cause the estimate to be sensitive to change is encouraged but not required.

Uninsured and Underinsured Risks

.77 As with pending litigation, uninsured and underinsured risks are not emerging types of risks but continue to be issues that may challenge auditors. These risks may arise in a number of ways, including having inadequate insurance for certain risks or no insurance at all, or coinsurance or deductible clauses in an insurance contract. The absence of insurance, or lack of sufficient insurance, against losses from various hazards or natural disasters constitutes an existing condition involving uncertainty about the amount and timing of any losses that may occur, thus meeting the definition of a contingency. However, as provided in paragraph of 28 of FASB Statement No. 5, “The absence of insurance does not mean that an asset has been impaired or a liability has been incurred at the date of an enterprise’s financial statements.” Furthermore, the conditions for accrual of a loss set forth in paragraph 8 of FASB Statement No. 5 are not satisfied prior to the occurrence of the event because until that time there is no diminution in the value of the property.

.78 If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 of FASB Statement No. 5 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency should be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. Although not required, FASB does not discourage disclosures related to uninsured or underinsured risks in appropriate circumstances.

.79 The CIRA also may have disclosure requirements if the insurance coverage does not comply with statutory requirements or the requirements of the CIRA’s governing documents. Failure to comply with statutory requirements is an illegal act as defined by AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1). The auditor’s consideration of the possibility of illegal acts is different for illegal acts that have a direct and material effect on the determination of financial statement amounts versus illegal acts related to violations of laws and regulations that relate more to an entity’s operating aspects than to its financial and accounting aspects and for which the financial statement effect is indirect (hereinafter referred to as other illegal acts). Paragraph .05 of AU section 317 states that “[t]he auditor’s responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for misstatements caused by error or fraud.” According to paragraph .07 of AU section 317, “For other illegal acts, the auditor should be aware of the possibility that such illegal acts may have occurred. If specific information comes to the auditor’s attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.” Paragraph .15 of AU section 317 states that “[t]he auditor should evaluate the adequacy of disclosure in the financial statements of the potential effects of an illegal act on the entity’s operations.” Readers may refer to AU section 317 for further guidance.

Certain Note Disclosures

.80 CIRA audits require the consideration of many unique issues uncommon to other industries, such as reserve studies, initial operating periods following turnover by the developer, losses from natural disasters, often strained relationships between the board of directors and unit owners, and an exceptionally litigious operating environment, among other issues that are generally not often associated with other industries. As such, the auditor may experience difficulty in determining all the items that require note disclosure in the financial statements. With this in mind, an overview of the current guidance may be helpful. The financial
statements should include any disclosures that would be appropriate to enhance the reader’s understanding. The vast majority, if not the entirety, of the authoritative accounting literature discusses the suggested and required content of note disclosures narrowly in the context of specific accounting requirements. However, paragraph 7 of FASB Concept No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, states that “[i]nformation disclosed in notes or parenthetically on the face of financial statements, such as significant accounting policies or alternative measures for assets or liabilities, amplifies or explains information recognized in the financial statements.” FASB Concept No. 5 also states that note disclosures are essential to understanding the information recognized in financial statements and have long been viewed as an integral part of financial statements prepared in accordance with GAAP.

Paragraph 167 of FASB Concept No. 6, Elements of Financial Statements—a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2), states that, “[a]lthough items that fail to qualify under the definitions of elements [that is, the broad classes of items that financial statements comprise, such as assets, liabilities, revenues, and expenses] during a period do not raise recognition issues, they may nevertheless raise issues about whether and, if so, how and at what amounts they should be disclosed. For example, contingencies that have not yet, and may never, become assets or liabilities may need to be estimated and disclosed.” The readers should note that FASB Concepts are not authoritative. Rather, they describe concepts and relations that will underlie future financial accounting standards and practices and in due course serve as a basis for evaluating existing standards and practices.

For other general perspectives on note disclosures, the auditing literature is an additional source for guidance and requirements. Paragraph .02 of AU section 431 states that “[t]he presentation of financial statements in conformity with [GAAP] includes adequate disclosure of material matters. These matters relate to the form, arrangement, and content of the financial statements and their appended notes, including, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth. An independent auditor [should consider] whether a particular matter should be disclosed in light of the circumstances and facts of which he [or she] is aware at the time.”

Summary of Recent Auditing and Attestation Pronouncements and Related Guidance

Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. This alert is intended to be used in conjunction with the Comprehensive Audit Risk Alert—2008 (product no. 022339kk); therefore, only industry specific pronouncements and related guidance or those of specific significance to the industry are summarized herein. For information on auditing and attestation standards issued subsequent to the writing of this alert, please refer to the AICPA Accounting and Auditing Website at www.aicpa.org/Professional+Resources/Accounting+and+Auditing. You also may look for announcements of newly issued standards in the CPA Letter, Journal of Accountancy, and in the quarterly electronic newsletter In Our Opinion, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.
### Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
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<tr>
<th>Statement on Auditing Standards (SAS) No. 115, Communicating Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, vol. 1, AU sec. 325)</th>
<th>Replacing SAS No. 112, Communicating Internal Control Related Matters Identified in an Audit, this standard defines the terms deficiency in internal control, significant deficiency, and material weakness; provides guidance on evaluating the severity of deficiencies in internal control identified in an audit of financial statements; and requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit. It is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.</th>
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<tr>
<td>Issue Date: October 2008</td>
<td>(Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])</td>
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<th>SAS No. 114, The Auditor’s Communication With Those Charged With Governance (AICPA, Professional Standards, vol. 1, AU sec. 380)</th>
<th>Replacing SAS No. 61, Communication With Audit Committees, this standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, to whom they should be communicated, and the form and timing of the communication. It is effective for audits of financial statements for periods beginning on or after December 15, 2006.</th>
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<tr>
<td>Issue Date: December 2006</td>
<td>(Applicable to audits conducted in accordance with GAAS)</td>
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<th>SAS No. 113, Omnibus Statement on Auditing Standards—2006 (AICPA, Professional Standards, vol. 1)</th>
<th>This standard does the following:</th>
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<tr>
<td>Issue Date: November 2006</td>
<td>• Revises the terminology used in the 10 standards of AU section 150, Generally Accepted Auditing Standards (AICPA, Professional Standards, vol. 1), to reflect terminology in AU section 120, Defining Professional Requirements in Statements on Auditing Standards (AICPA, Professional Standards, vol. 1).</td>
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<tr>
<td>(Applicable to audits conducted in accordance with GAAS)</td>
<td>• Adds a footnote to the headings before paragraphs .35 and .46 in AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), to provide a clear link between the auditor’s consideration of fraud, the auditor’s assessment of risk, and the auditor’s procedures in response to those assessed risks.</td>
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<td>• Replaces throughout the SASs the term completion of fieldwork with the term date of the auditor’s report.</td>
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<td>• Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor’s report.</td>
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<tr>
<th>SAS Nos. 104–111, the risk assessment standards</th>
<th>The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits; focusing on identifying and assessing the risks of material misstatements; further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels; and improving the linkage between the risks, controls, audit procedures, and conclusions. These eight SASs became effective for audits of financial statements for periods beginning on or after December 15, 2006.</th>
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<tr>
<td>Issue Date: March 2006</td>
<td>(Applicable to audits conducted in accordance with GAAS)</td>
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<td>Statement on Standards for Attestation Engagements (SSAE) No. 15, <em>An Examination of an Entity’s Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements</em> (AICPA, Professional Standards, vol. 1, AT sec. 501)</td>
<td>This statement establishes requirements and provides guidance that applies when a practitioner is engaged to perform an examination of the design and operating effectiveness of an entity’s internal control over financial reporting (examination of internal control) that is integrated with an audit of financial statements (integrated audit). This SSAE is effective for integrated audits for periods ending on or after December 15, 2008. Earlier implementation is permitted.</td>
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<tr>
<td>SSAE No. 14, SSAE Hierarchy (AICPA, Professional Standards, vol. 1, AT sec. 50)</td>
<td>This standard identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in AT section 20, <em>Defining Professional Requirements in Statements on Standards for Attestation Engagements</em> (AICPA, Professional Standards, vol. 1). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.</td>
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<tr>
<td>Interpretation No. 19, “Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board,” of AU section 508 (AICPA, Professional Standards, vol. 1, AU sec. 9508 par. .93–.97)</td>
<td>This interpretation of AU section 508 addresses the application of AU section 508 in reporting on financial statements prepared in conformity with IFRS.</td>
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<th>Interpretation No. 2, “Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board,” of AU section 534, Reporting on Financial Statements Prepared for Use in Other Countries (AICPA, Professional Standards, vol. 1, AU sec. 9534 par. .05–.08)</th>
<th>This interpretation of AU section 534 addresses the application of AU section 534 in reporting on financial statements prepared in conformity with IFRS.</th>
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<tr>
<td>Issue Date: May 2008</td>
<td>(Interpretive publication)</td>
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<td>Issue Date: May 2008</td>
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<td>Statement of Position (SOP) 07-2, Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisers, or Other Service Providers (AICPA, Technical Practice Aids, AUD sec. 14,430)</td>
<td>This statement addresses the application of SSAEs primarily to examination engagements in which a practitioner reports on the suitability of the design and operating effectiveness of a service provider’s controls in achieving specified compliance control objectives. Examples of the service providers addressed by this SOP are investment advisers, custodians, transfer agents, administrators, and principal underwriters that provide services to investment companies, investment advisers, or other service providers.</td>
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<tr>
<td>Issue Date: October 2007</td>
<td>(Interpretive publication)</td>
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<tr>
<td>AICPA Technical Questions and Answers (TIS) section 1100.15, “Liquidity Restrictions” (AICPA, Technical Practice Aids)</td>
<td>This question and answer discusses auditing and accounting issues related to withdrawal restrictions placed on short term investments by a money market fund or its trustee.</td>
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<td>Issue Date: October 2008</td>
<td>(Nonauthoritative)</td>
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### Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
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<tr>
<th>Section/Issue</th>
<th>Description</th>
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| TIS sections 8200.05–16 (AICPA, Technical Practice Aids) | These questions and answers in TIS section 8200, Internal Control (AICPA, Technical Practice Aids), were developed in response to common questions received from members regarding the implementation of SAS Nos. 104–111. Some of the topics include the following:  
  - Consideration of internal controls that are less formal or not documented by the client  
  - Whether the auditor may suggest improvements to a client’s internal control  
  - Assessing inherent risk in relation to the consideration of control risk  
  - The frequency of walkthroughs that are used as the basis for the auditor’s understanding of internal control  
  - Considerations in obtaining an understanding of, evaluating, and documenting controls that the auditor believes are nonexistent or ineffective  
  - Assessing control risk at the maximum level  
  - Considerations for developing a substantive audit strategy |
| Issue Date: April and May 2008 (Nonauthoritative) |
| TIS section 9120.08, “Part of an Audit Performed in Accordance With International Standards on Auditing” (AICPA, Technical Practice Aids) | This question and answer discusses the implications to the principal auditor’s report when part of an audit is conducted by other independent auditors in accordance with International Standards on Auditing or another country’s auditing standards. |
| Issue Date: April 2008 (Nonauthoritative) |
| TIS section 9100.06, “The Effect of Obtaining the Management Representation Letter on Dating the Auditor’s Report” (AICPA, Technical Practice Aids) | This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor’s report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor’s report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that it will sign the representation letter, without exception, on or before the date of the representations. |
| Issue Date: May 2007 (Nonauthoritative) |
| TIS section 8350.01, “Current Year Audit Documentation Contained in the Permanent File” (AICPA, Technical Practice Aids) | This question and answer discusses whether the provisions of AU section 339, Audit Documentation (AICPA, Professional Standards, vol. 1), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that AU section 339 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year’s audit report. |
| Issue Date: May 2007 (Nonauthoritative) |
| AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, Audit Confirmations (AICPA, Technical Practice Aids, PA sec. 16,240) | This practice alert is a response to practitioners’ current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations, among other topics. |
| Revised: June 2007 (Nonauthoritative) |

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Recent Auditing and Attestation Pronouncements and Related Guidance

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<th>AICPA PIF PA 07-1, Dating of the Auditor’s Report and Related Practical Guidance (AICPA, Technical Practice Aids, PA sec. 16,290)</th>
<th>This practice alert provides guidance regarding application of certain provisions of AU section 339, primarily related to dating the auditor’s report.</th>
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<td>Issue Date: January 2007 (Nonauthoritative)</td>
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Compilation and Review Issues and Developments

.84 The Audit Risk Alert Compilation and Review Developments—2008 (product no. 022309kk) is an important tool, designed to help you plan and perform your compilation and review engagements. That alert discusses recent Standards for Accounting and Review Services (SSARSs) developments, addresses emerging practice issues, points out pitfalls that frequently occur in compilation and review engagements, and provides valuable information regarding current accounting developments.

Rescission of SOP 93-5

.85 As part of the conforming changes to the CIRA guide, updated as of May 1, 2008, the Accounting and Review Services Committee (ARSC) rescinded SOP 93-5, Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations. Interpretative guidance previously included in the SOP has been conformed and moved to chapter 8 of the CIRA guide. Topics previously addressed in the SOP that are now reflected in the CIRA guide include the performance and reporting requirements toward the required supplementary information accompanying the basic financial statements.

Issuance of SSARS No. 17

.86 On February 13, 2008, the ARSC issued SSARS No. 17, Omnibus Statement on Standards for Accounting and Review Services—2008 (AICPA, Professional Standards, vol. 2), which amends some of the guidance for compilation and review engagements and is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008, with early application permitted. Readers may refer to the Audit Risk Alert Compilation and Review Developments—2008 for a detailed discussion of this SSARS. Those provisions that may have significant relevance to CIRAs include the introduction of definitions for management and those charged with governance and the new guidance with respect to an accountant’s consideration of the entity’s ability to continue as a going concern during the performance of compilation or review procedures.

.87 SSARS No. 17 also incorporates guidance with respect to analytical procedures in a review engagement as a nonauthoritative exhibit (exhibit A) to the codification of SSARSs. In addition to exhibit A, “Analytical Procedures in a Review Engagement,” the ARSC has separately issued exhibit B, “Going Concern Considerations,” and exhibit C, “Subsequent Events Considerations,” to provide nonauthoritative accounting guidance to assist practitioners performing compilation and review engagements. These exhibits can be found online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee/Nonauthoritative+Exhibits+to+the+SSARSs+Codification.htm.

Issuance of SSARS No. 16

.88 On December 18, 2007, the ARSC issued SSARS No. 16, Defining Professional Requirements in Statements on Standards for Accounting and Review Services (AICPA, Professional Standards, vol. 2, AR sec. 20), which defines the terminology that the ARSC will use to describe the degree of responsibility that the requirements
impose on the accountant. The ARSC believes that by defining the levels of responsibilities that accountants have in compilation and review engagements in a fashion similar to Statement on Auditing Standards No. 102, Defining Professional Requirements in Statements on Auditing Standards (AICPA, Professional Standards, vol. 1, AU sec. 120), standards for compilation and review engagements would be clarified, and the imperatives used in such standards would then be consistent with the standards for audit engagements.

**Accounting Issues and Developments**

**Convergence with International Financial Reporting Standards**

.89 Since the signing of the Norwalk Agreement by FASB and the International Accounting Standards Board (IASB), the bodies have had a common goal—one set of accounting standards for international use. In this agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. In 2005 meetings, FASB and the IASB reaffirmed their commitment to the convergence of U.S. GAAP and International Financial Reporting Standards (IFRS). A common set of high quality, globally accepted standards remains the long-term strategic priority of both FASB and the IASB.

.90 FASB and the IASB have undertaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and IFRS. These ongoing joint projects address the conceptual framework, business combinations, financial statement presentation, and revenue recognition. For more information on the status of this project go to www.fasb.org and www.iasb.org.

**SEC Eases Acceptance of IFRS Financial Statements**

.91 On December 21, 2007, the SEC took a major step toward easing the acceptance of IFRS financial statements by adopting rules to accept from foreign private issuers financial statements prepared in accordance with IFRS as issued by the IASB without reconciliation to U.S. GAAP. This rule marks an important step in the process toward the development of a single set of high quality, globally accepted accounting standards. This rule became effective March 4, 2008. Readers can access this rule at www.sec.gov/rules/final/2007/33-8879.pdf.

.92 More than 100 countries now either require or allow the use of IFRS for the preparation of financial statements by listed companies, and additional countries are moving to do the same. This recent movement to IFRS outside the U.S. has resulted in an increase of filings with the SEC of foreign private issuers that represent in the footnotes to their financial statements that their financial statements comply with IFRS as published by the IASB—from a relative few in 2005 to approximately 110 in 2006. The SEC expects this number will continue to increase in the future, particularly pursuant to Canada’s announced move to IFRS, because there currently are approximately 500 foreign private issuers from Canada.

.93 This movement to IFRS also has begun to affect U.S. issuers, in particular those with a significant global footprint. For instance, certain U.S. issuers may compete for capital globally in industry sectors in which a critical mass of non-U.S. companies report under IFRS. Also, U.S. issuers with subsidiaries located in jurisdictions that have moved to IFRS may prepare those subsidiaries’ financial statements in IFRS for purposes of local regulatory or statutory filings. Readers should remain alert to developments regarding convergence.

**IFRS “Roadmap”**

.94 On November 14, 2008, the SEC released for public comment, in the format of a proposed rule, a roadmap that could lead to the use of IFRS by U.S. issuers beginning in 2014. The SEC would make a decision in 2011 on whether adoption of IFRS is in the public interest and would benefit investors. The proposed multiyear plan sets out several milestones that, if achieved, could lead to the use of IFRS by U.S. issuers in their filings with the SEC.
The top 20 companies in each industry, as determined by market capitalization, could elect to begin filing IFRS financial statements for fiscal periods ending after December 15, 2009. If, in 2011, the SEC adopts IFRS for all filers, the roadmap suggests mandatory filing for large accelerated filers beginning in 2014, accelerated filers in 2015, and nonaccelerated filers in 2016. The 90 day comment period ends on February 19, 2009.

The proposed roadmap sets forth seven milestones that will influence the SEC’s decision to adopt IFRS for all filers. These milestones relate to improvements in accounting standards, the accountability and funding of the International Accounting Standards Committee Foundation, the improvement in the ability to use interactive data for IFRS reporting, education and training relating to IFRS, limited early use of IFRS where this would enhance comparability for U.S. investors, the anticipated timing of future rulemaking by the SEC, and the implementation of the mandatory use of IFRS by U.S. issuers.

Additionally, the roadmap discusses two alternatives for U.S. issuers that elect to use IFRS to disclose U.S. GAAP information. Proposal A suggests a U.S. issuer that elects to file IFRS financial statements would provide the reconciling information from U.S. GAAP to IFRS called for under IFRS 1, First-Time Adoption of International Financial Reporting Standards, in a footnote to its audited financial statements. This information would include the restatement of and reconciliation from prior year’s financial statements and the related disclosures.

Proposal B suggests that U.S. issuers that elect to file IFRS financial statements would provide the reconciling information from U.S. GAAP to IFRS required under IFRS 1 and also would disclose on an annual basis certain unaudited supplemental U.S. GAAP financial information covering a three year period. This unaudited supplemental financial information would be in the form of a reconciliation from IFRS to U.S. GAAP.

The roadmap does not address how the SEC would mandate IFRS; however, it noted an option would be, “for the FASB to continue to be the designated standard setter for purposes of establishing the financial reporting standards in issuer filings with the Commission. In this option our presumption would be that the FASB would incorporate all provisions under IFRS, and all future changes to IFRS, directly into generally accepted accounting principles as used in the United States. This type of approach has been adopted by a significant number of other jurisdictions when they adopted IFRS as the basis of financial reporting in their capital markets.”


AICPA Launches IFRS.com Web Site

The AICPA is calling for an orderly transition and reasonable time frame of three to five years for the U.S. accounting profession to adopt IFRS. During a FASB forum on June 16, 2008, held to facilitate an open dialogue about whether and how to move the U.S. financial reporting system to IFRS and define the next steps in that process, it was noted that awareness of IFRS is growing, but most believe it will take three to five years to prepare.

To assist in both awareness building and education, the AICPA launched a new Web site, www.ifrs.com, in May 2008. The site provides current information about developments in international convergence. The growing acceptance of IFRS as a basis for U.S. financial reporting represents a fundamental change for the U.S. accounting profession. Acceptance of a single set of high-quality accounting standards for worldwide use by public companies has been gaining momentum around the globe for the past few years.

Developed by the AICPA, in partnership with its marketing and technology subsidiary, cpa2biz, IFRS.com provides a comprehensive set of resources for accounting professionals, auditors, financial managers, audit committees, and other users of financial statements.
The Web site features tools and resources to help CPAs get acquainted with IFRS, the surrounding issues, and available support. Resources include a history of convergence, a high-level overview of the differences between IFRS and U.S. GAAP, frequently asked questions, articles, textbooks, continuing professional education (CPE) courses and live conference training, helpful links, and assistance for audit committee members.

FASB Accounting Standards Codification™

On January 15, 2008, FASB launched the verification period of FASB Accounting Standards Codification™ (ASC). FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing all authoritative literature in a topically organized structure. FASB ASC includes all accounting standards issued by a standard setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, AICPA, Emerging Issues Task Force (EITF), and related literature. FASB ASC also includes relevant authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance.

The purpose of FASB ASC is not to change GAAP, but rather to reorganize thousands of GAAP pronouncements into approximately 90 topics. At the end of the extended verification period, FASB is expected to formally approve FASB ASC as the single source of authoritative U.S. accounting and reporting standards, other than guidance issued by the SEC. On July 1, 2009, FASB will supersede all then-existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the codification will become nonauthoritative. FASB ASC can be accessed at http://asc.fasb.org/home.

Constituents are encouraged to use FASB’s online FASB ASC Research System free of charge and provide feedback to FASB on the codification.

The AICPA has published the Financial Reporting Alert FASB Codification Developments—2008 (product no. 029209kk). This Financial Reporting Alert is intended to provide a better understanding of FASB ASC, outline its structure, as well as provide case studies on navigating the FASB ASC Research System and performing accounting research.

Fair Value Measurements

FASB Statement No. 157

As previously mentioned, a CIRA may have diverse investment holdings and other assets, liabilities, and components of equity that may be subject to measurement or disclosure at fair value in the financial statements. In September 2006, FASB issued FASB Statement No. 157 to provide enhanced guidance for using fair value to measure assets and liabilities. This standard defines fair value and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances.

Prior to this statement, the definitions of fair value differed, and guidance for applying those definitions was dispersed among many accounting pronouncements. Differences in the existing guidance created inconsistencies that added to the complexity in applying GAAP. FASB Statement No. 157 provides increased consistency and comparability in fair value measurements. Expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the use of fair value in the financial statements, the inputs used to develop the measurements, and the effect of the measurements on earnings (or changes in net assets) for the period.

In February 2008, FASB issued FASB Staff Position (FSP) FAS 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13, which amends FASB Statement No. 157 to
exclude FASB Statement No. 13, *Accounting for Leases*, and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under FASB Statement No. 13. However, this scope exception does not apply to assets acquired and liabilities assumed in a business combination that are required to be measured at fair value under FASB Statement No. 141, *Business Combinations*, or FASB Statement No. 141 (revised 2007), *Business Combinations*, regardless of whether those assets and liabilities are related to leases. This FSP is effective upon the initial adoption of FASB Statement No. 157.

.112 FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. However, in February 2008, FASB also issued FSP FAS-157-2, *Effective Date of FASB Statement No. 157*, which is effective upon issuance. This FSP delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years, for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow FASB and its constituents to consider the various implementation issues associated with FASB Statement No. 157. In October 2008, FASB issued FSP FAS-157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*, which clarifies FASB Statement No. 157’s application in an inactive market and also amends the standard to include an illustrative example. See the section of this alert entitled “Measurements of Fair Value in Illiquid Markets” for further discussion of FSP FAS-157-3. Readers can access the full text of FASB Statement No. 157 and the previously referenced FSPs on the FASB Web site at [www.fasb.org](http://www.fasb.org).

**Measurements of Fair Value in Illiquid Markets**

.113 Most of the subprime mortgages making headlines were ultimately financed via securitization issuances. As a result of the growing numbers of defaults and foreclosures and uncertainty about the future, potential investors in these securities and potential lenders to issue these securities have become almost nonexistent, causing a liquidity crisis. This has caused significant declines in the values of existing loans and mortgage backed securities held by both lenders and investors, given the lack of demand. This also has spread to a lack of demand for investments in collateralized debt obligations (CDOs), because many CDOs hold securities backed by subprime mortgages, and even the short-term commercial paper market.

.114 Given the state of the market, confusion exists about the use of “market” quotes and whether current market prices represent fair value in accordance with FASB Statement No. 157 or are in actuality distressed sales. To clarify the application of FASB Statement No. 157 in an inactive market, in October 2008, FASB issued FSP FAS-157-3. This FSP also amends FASB Statement No. 157 to include an illustrative example. FSP FAS-157-3 noted the consistency between the guidance provided in it and the guidance provided in the SEC and FASB press release. Readers are encouraged to review the full text of the FSP and the amended standard (inclusive of its recently added illustrative example) on the FASB Web site at [www.fasb.org](http://www.fasb.org). The FSP was effective upon issuance, including any prior periods for which financial statements have not been issued. Any revisions from changes in valuation techniques or their application shall be accounted for as a change in accounting estimate in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*; however, the disclosure provisions of FASB Statement No. 154 for such revisions are not required.

.115 FSP FAS-157-3 noted, “Broker (or pricing service) quotes may be an appropriate input when measuring fair value, but they are not necessarily determinative if an active market does not exist for the financial asset... In weighing a broker quote as an input to a fair value measurement, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence.” As discussed in paragraph 7 of FASB Statement No. 157, “An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).” Low transaction
volume involving such assets does not necessarily translate into forced sales, nor does it necessarily mean the market is inactive. To deem a transaction forced or disorderly, persuasive evidence and judgment are required.

.116 If transaction volume is too low to provide accurate pricing information and therefore is not a Level 1 input, those observable transactions are to be considered Level 2 inputs or even Level 3 inputs if they are significantly adjusted. The AICPA Center for Audit Quality’s (CAQ) October 2007 white paper on the topic noted some characteristics of an inactive market are “few transactions for the asset, the prices are not current, price quotations vary substantially, or in which little information is released publicly.” In describing an inactive market as well, the SEC and FASB press release noted, “A significant increase in the spread between the amount sellers are ‘asking’ and the price that buyers are ‘bidding,’ or the presence of a relatively small number of ‘bidding’ parties, are indicators that should be considered in determining whether a market is inactive.”

.117 The lack of an active market and the information obtained from it require further analysis. According to FSP FAS 157-3, “[I]n cases where the volume and level of trading activity in the asset have declined significantly, the available prices vary significantly over time or among market participants, or the prices are not current, the observable inputs might not be relevant and could require significant adjustment.” Further, the SEC and FASB press release noted, “[I]n some cases using unobservable inputs (level 3) might be more appropriate than using observable inputs (level 2); for example, when significant adjustments are required to observable inputs it may be appropriate to utilize an estimate based primarily on unobservable inputs.” When significant adjustments are made to an observable input (Level 2), it becomes a Level 3 fair value measurement.

.118 Paragraph C85 of FASB Statement No. 157 states, “[T]he reporting entity may use its own data to develop unobservable inputs, provided that there is no information reasonably available without undue cost and effort that indicates that market participants would use different assumptions in pricing the asset or liability.” A reporting entity is prohibited from ignoring observable transactions or assumptions that are reasonably available without undue cost and effort.

.119 FSP FAS 157-3 concludes, “[T]he use of a reporting entity’s own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available.” Similarly, the SEC and FASB press release noted, “In some cases, multiple inputs from different sources may collectively provide the best evidence of fair value. In these cases expected cash flows would be considered alongside other relevant information. The weighting of the inputs in the fair value estimate will depend on the extent to which they provide information about the value of an asset or liability and are relevant in developing a reasonable estimate.”

.120 The AICPA, in October 2008 (as mentioned in the “Audit Risks Arising From Current Economic Conditions” section), issued a question and answer around liquidity restrictions. TIS section 1100.15 provides useful information to accountants and auditors when an entity’s short-term investments (such as money market funds) have become restricted by the fund (or its trustee). The full question and answer can be obtained from the AICPA’s Web site, www.aicpa.org.

**FASB Statement No. 159**

.121 Subsequent to the issuance of FASB Statement No. 157, FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*. This statement is expected to expand the use of fair value measurement, which is consistent with FASB’s long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159 allows entities to choose to measure many financial instruments and certain other items at fair value. The standard permits an entity to elect the fair value option on an instrument-by-instrument basis; once the election is made, it is irrevocable. This statement’s objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently, without having to apply complex hedge accounting provisions.
In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments, and FASB Statement No. 157.

FASB Statement No. 159 is effective as of the beginning of an entity’s first fiscal year after November 15, 2007. FASB and the SEC expressed concern in the way some early adopters applied the transition provisions of the standard. The CAQ issued an alert on this development in April 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles based standard, such as this, is applied in a good faith manner consistent with those objectives and principles. Specifically the alert warns auditors to “be alert for circumstances in which an entity proposes to adopt FAS 159 in a manner that is contrary to the principles and objectives outlined in the standard.” The alert can be accessed at www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf. Readers can access the full text of FASB Statement No. 159 on the FASB Web site at www.fasb.org.

Summary of Recent Accounting Pronouncements and Related Guidance

Presented in the following table is a list of recently issued accounting pronouncements and related guidance. This alert is intended to be used in conjunction with the Comprehensive Audit Risk Alert—2008 (product no. 022339kk); therefore, only industry specific pronouncements and related guidance or those of specific significance to the industry are summarized herein. For information on accounting standards issued subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You also may look for announcements of newly issued standards in the CPA Letter and Journal of Accountancy.

<table>
<thead>
<tr>
<th>Recent Accounting Pronouncements and Related Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>FASB Statement No. 162 (May 2008)</td>
</tr>
<tr>
<td>FASB Statement No. 161 (March 2008)</td>
</tr>
<tr>
<td>FASB Statement No. 160 (December 2007)</td>
</tr>
<tr>
<td>FASB Statement No. 141 (revised 2007) (December 2007)</td>
</tr>
<tr>
<td>FASB Statement No. 158 (September 2006)</td>
</tr>
<tr>
<td>FASB Statement No. 157 (September 2006)</td>
</tr>
</tbody>
</table>
## Recent Accounting Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Pronouncement</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>FASB Interpretation No. (FIN) 48 (June 2006)</td>
<td>Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109. FASB Staff Position (FSP) FIN 48-2, Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises, issued in February 2008, defers the effective date of FIN 48 for certain nonpublic enterprises, as defined in the FSP, to the annual financial statements for fiscal years beginning after December 15, 2007.</td>
</tr>
<tr>
<td>FASB Staff Positions (FSPs) (Various dates)</td>
<td>Go to <a href="http://www.fasb.org/fasb_staff_positions/">www.fasb.org/fasb_staff_positions/</a> for a complete list of FSPs.</td>
</tr>
<tr>
<td>AICPA Statement of Position (SOP) 07-1 (AICPA, Technical Practice Aids, ACC sec. 10,930)</td>
<td>Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies. In February 2008, FASB issued FSP SOP 07-1-1, Effective Date of AICPA Statement of Position 07-1, which indefinitely defers the effective date of SOP 07-1. Entities that early adopted SOP 07-1 before December 15, 2007 are permitted, but not required, to continue to apply the provisions of the SOP. No other entities may adopt the provisions of the SOP, subject to the exception in the following sentence: “If a parent entity that early adopted the SOP chooses not to rescind its early adoption, an entity consolidated by the parent entity that is formed or acquired after that parent entity’s adoption of the SOP must apply the provisions of the SOP in its standalone financial statements.”</td>
</tr>
<tr>
<td>Technical Questions and Answers (TIS) section 1100.15 (AICPA, Technical Practice Aids) (Nonauthoritative)</td>
<td>This question and answer discusses auditing and accounting issues related to withdrawal restrictions placed on short term investments by a money market fund or its trustee.</td>
</tr>
<tr>
<td>TIS sections 6910.25–.28 (AICPA, Technical Practice Aids) (Nonauthoritative)</td>
<td>These questions and answers discuss financial statement presentation considerations for investment companies.</td>
</tr>
<tr>
<td>TIS sections 6140.20–.22 (AICPA, Technical Practice Aids) (Nonauthoritative)</td>
<td>These questions and answers discuss not-for-profit organizations’ fund-raising expenses.</td>
</tr>
<tr>
<td>TIS section 6931.08–.10 (AICPA, Technical Practice Aids) (Nonauthoritative)</td>
<td>These questions and answers discuss various employee benefit plan topics.</td>
</tr>
<tr>
<td>AICPA Practice Guide (Nonauthoritative)</td>
<td>Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48</td>
</tr>
</tbody>
</table>

.125 The Comprehensive Audit Risk Alert—2008 and other AICPA industry-specific alerts also contain summaries of recent pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or visit www.cpa2biz.com.
Internal Control Issues and Developments

Overview

.126 CIRAs often find it difficult to establish and maintain an effective internal control structure due to the inherent limitations of their governance structure. Frequently, the CIRA’s board of directors shoulders the responsibility for having effective internal controls because, for many CIRAs, few, if any, paid association management staff have the requisite competence and experience to address such matters. Board members may not have the necessary competence or experience either. When these conditions exist, the auditor is more likely to find that the CIRA’s internal control structure contains deficiencies, which impair the CIRA’s ability to achieve its objectives with regards to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

.127 For purposes of the following discussion on internal control, the use of the term management also refers to the board of directors, due to the unique governance characteristics common among CIRAs. Generally speaking, members of a CIRA’s board of directors have significant management responsibilities, including the responsibility for the CIRA’s financial administration. If the CIRA utilizes a management company, it is not likely that the agreement transfers the authority for the entirety of the management function, as the term management is defined in AU section 380, The Auditor’s Communication With Those Charged With Governance (AICPA, Professional Standards, vol. 1), to the management company, in which case the board of directors would still be responsible for certain key management duties.

Common Internal Control Issues in the CIRA Industry

.128 AU section 314 establishes requirements and provides guidance on the auditor’s understanding of an entity’s internal control. Generally, controls that are relevant to the audit pertain to the entity’s objective of preparing financial statements in conformity with GAAP or other comprehensive basis of accounting (OCBOA), depending on the applicable basis of accounting. The CIRA also will have controls that are not necessarily relevant to the audit, such as operational controls that do not relate to information or data that the auditor may evaluate or use in applying audit procedures.

.129 Of the five interrelated components of internal control defined in paragraph .41 of AU section 314, CIRA’s may struggle with many of them due to their small size and governance by nonexpert volunteers, among other factors. The following list identifies the five interrelated components of internal control and includes potential areas of deficiencies common to CIRAs:

1. Control Environment. The control environment “sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.” Among other important elements, it consists of management’s commitment to competence; the participation of those charged with governance; management’s attitudes and actions toward financial reporting; accounting functions; personnel; and the attitudes, awareness, and actions of those charged with governance concerning the CIRA’s internal control and its importance in achieving reliable financial reporting. A key concept for CIRAs to understand is that the auditor cannot be part of a CIRA’s internal control. An auditor’s response to a CIRA’s control weakness, such as having to draft the financial statements, does not change the fact that a control weakness exists.

The following aspects of the control environment of CIRAs may be particularly susceptible to deficiencies:

a. Management’s philosophy toward business risks and financial reporting, including the frequency with which the reserve study for major repairs and replacements is updated and management’s attitude toward obtaining the opinions of third party professionals for strategic decision making.
b. Management’s philosophy toward the CIRA’s continuing compliance with the CIRA’s funding plan for accumulating the financial resources necessary to fund the estimated current or future costs of future major repairs and replacements

c. Management’s programs and controls to address the risk of fraud, an example of which is the use of closed bids for contracts

d. Management’s programs and controls to determine the existence of related party relationships and the inappropriate use of related parties, an example of which may include disclosure forms that board members must complete

2. The Entity’s Risk Assessment Process. This component is the process for the identification, analysis, and management of risks relevant to the preparation of the financial statements, which include both external and internal events and circumstances that may occur and adversely affect the CIRA’s ability to initiate, authorize, record, process, and report financial data consistent with the assertions of management in the financial statements. CIRAs may not have a formal risk assessment process, in which case the auditor should inquire with management about how risks to the business are identified by management and how they are addressed.

The following aspects of the CIRA’s risk assessment process may be particularly susceptible to deficiencies:

a. Management’s consideration and analysis of unrecorded liabilities, such as those potentially related to pending or settled litigation

b. Management’s consideration and analysis of significant estimates applicable to the financial statements, such as the allowance for bad debts

c. Management’s consideration and analysis of changes in the operating environment (for example, the effects of an economic downturn or significant economic indicators like mortgage interest rates, employment, and housing); the effects of changes in laws and regulations (including tax law); and the effects of rising prices of key inputs, including energy, insurance, and construction costs

3. Information and Communication Systems. This component consists of the information system relevant to financial reporting objectives, including the accounting system and the procedures established to initiate, record, process, and report transactions, including those to maintain accountability for the related assets, liabilities, and equity. Also part of this component is the role communication plays in establishing an understanding of individual roles and responsibilities pertaining to internal control relevant to financial reporting.

The following aspects of the CIRA’s information and communication systems may be particularly susceptible to deficiencies:

a. Management’s commitment to provide sufficient resources to address security risks related to information technology, including unauthorized access to information technology systems

b. The procedures implemented to initiate, authorize, record, and process journal entries in the accounting system

c. The procedures implemented to override the automated processing of transactions by the information system

d. The procedures implemented to ensure that information required to be presented and disclosed in the financial statements is accumulated, recorded, processed, summarized, and appropriately reported

4. Control Activities. This component consists of “the policies and procedures that help ensure that management directives are carried out.” Ordinarily, control activities that may be relevant to the
audit include those related to authorization, segregation of duties, safeguarding of assets, and asset accountability, including, for example, reconciliations of the general ledger to the detailed records.

The following common control activities are normally relevant to the audit of a CIRA and may be particularly susceptible to deficiencies:

a. Performance of monthly bank reconciliations
b. Review and approval of cash disbursements
c. Review and approval of cash transfers between bank accounts
d. Performance of collection procedures for delinquent assessments
e. Review and approval of bad debt write-offs
f. Review and approval of waiving the funding for capital replacement and deferred maintenance items, and compliance with the governing documents and state statutes
g. Periodic review and updating of reserve study on future major repairs and replacements
h. Periodic review and updating of insurance coverage so that exposure to uninsured losses, either in the form of significant deductibles or insufficient coverage, is identified and appropriately considered
i. Review and approval of the annual budget
j. For CIRAs that utilize the services of a management company, for which the terms of the agreement meet the criteria in AU section 324, Service Organizations (AICPA, Professional Standards, vol. 1), to have the management company considered a service organization, the periodic review and testing of the relevant controls at the service organization (for example, the reperformance of selected items processed by the service organization or reconciliation of certain output reports from the service organization to the CIRA’s source documents)
k. Review and approval of the internally prepared financial statements being audited

5. Monitoring of Controls. This component consists of the steps taken by the CIRA to monitor internal control over financial reporting and includes consideration of the sources of the information related to those steps and how those steps are used to initiate corrective actions to its controls. Monitoring is done to ensure that controls, once implemented, continue to operate effectively. Also, for smaller CIRAs, both the amount and detail of their monitoring functions might be increased to compensate for the lack of enough employees to provide for adequate segregation of duties. One example of a monitoring control is management’s review of whether the bank reconciliations are being prepared on a timely basis.

Those CIRAs that utilize management companies that meet the criteria set forth in AU section 324 to have the management company considered a service organization have the same monitoring obligations for the internal control performance of the service organization as management does for the CIRA’s own internal control performance. An effective monitoring activity may include obtaining a service auditor’s report or a service auditor’s agreed-upon procedures report that describes the results of the service auditor’s tests of controls relevant to the CIRA’s internal control as it relates to the audit of the CIRA’s financial statements.

Recent AICPA Independence and Ethics Pronouncements

.130 Audit Risk Alert Independence and Ethics Developments—2008 (product no. 022479kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.
On the Horizon

.131 You should keep abreast of accounting, auditing, or compilation and review developments and upcoming guidance that may affect your engagements. The following sections present brief information about some ongoing projects that have particular significance to CIRAs or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.132 The following table lists the various standard setting bodies’ Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.

<table>
<thead>
<tr>
<th>Standard-Setting Body</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>AICPA Auditing Standards Board (ASB)</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/</a></td>
</tr>
<tr>
<td>AICPA Accounting and Review Services Committee (ARSC)</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee/">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee/</a></td>
</tr>
<tr>
<td>Financial Accounting Standards Board (FASB)</td>
<td><a href="http://www.fasb.org">www.fasb.org</a></td>
</tr>
<tr>
<td>Professional Ethics Executive Committee (PEEC)</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/">www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/</a></td>
</tr>
</tbody>
</table>

Auditing Pipeline—Nonissuers

ASB Clarity Project

.133 In response to growing concerns about the complexity of standards, the Auditing Standards Board (ASB) has commenced a large-scale “clarity” project to revise all existing auditing standards so they are easier to read and understand. Over the next two or three years, the ASB will be redrafting all of the existing auditing sections contained in the Codification of Statements on Auditing Standards (AU sections of the AICPA’s Professional Standards), to apply the clarity drafting conventions and converge with the International Standards on Auditing issued by the International Auditing and Assurance Standards Board. The ASB proposes that, except to address current issues, all redrafted standards will become effective at the same time. Only those standards needing to address current issues would have earlier effective dates. The ASB believes that a single effective date will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. Currently, the date is expected to be for audits of financial statements for periods beginning no earlier than December 15, 2010. This date depends on satisfactory progress being made, and will be amended should that prove necessary. See the Clarity Project Explanatory Memorandum and the discussion paper Improving the Clarity of ASB Standards at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm.
Compilation and Review Pipeline

The Reliability Framework

.134 A potentially significant development in progress addresses the obstacles to providing reliable financial reports created by the independence rules. At its meeting in April/May 2008, the ARSC, a senior technical committee of the AICPA, approved a project to develop a framework for the performance of compilation and review engagements. Such a framework would permit the expression of limited assurance on reviewed financial statements for an entity, with respect to whom the accountant is not independent due to the performance of certain control activities.

.135 The Reliability Task Force (task force) was formed with the charge of developing a draft SSARS that would expand the applicability of the compilation and review literature to enable an accountant who maintains his or her objectivity to provide limited assurance on an entity’s financial statements, even though the accountant’s independence may be impaired because he or she performed certain control activities for the entity. These types of services are extremely valuable in enhancing financial statement reliability for entities that otherwise would be unable to prepare accurate accounting records and financial statements.

.136 The task force believes that accountants should not be prohibited from expressing some level of limited assurance when an independence impairment has been caused by the performance of a control service that actually improves the reliability of the information. Such a prohibition is not practicable for many smaller entities and not necessarily in the public interest. These issues were discussed with the ARSC at its meeting in August 2008. The ARSC plans to issue a draft document for public comment in the first half of 2009.

Accounting Pipeline

.137 A number of accounting projects and pronouncements are currently in progress. For a summary of significant accounting projects and pronouncements, refer to the Comprehensive Audit Risk Alert—2008 (product no. 022339kk). Such in-progress issues include the following:

- Accounting for hedging activities exposure draft
- Accounting for contingencies exposure draft
- Phase 2 of the fair value project
- Transfers of financial assets project
- Earnings per share convergence project
- Income tax convergence project
- Leases project
- Reporting discontinued operations project
- Going concern proposed statement
- Subsequent events proposed statement
- Amendments to FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities—an interpretation of ARB No. 51, proposed statement

Proposed FASB Emerging Issues Task Force Issues and Staff Positions

.138 Proposed FASB EITF Issues. Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

.139 Proposed FASB Staff Positions (FSPs). A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.
Resource Central

The following are various resources that practitioners engaged in the CIRA industry may find beneficial.

Publications

Practitioners may find the following publications useful. Choose the format best for you—online, print, or CD-ROM.

- **Audit and Accounting Guide Common Interest Realty Associations** (2008) (product no. 012578kk [paperback], WCI-XXkk [online with the associated Audit Risk Alert], or DCI-XXkk [CD-ROM with the associated Audit Risk Alert])
- **Audit Guide Analytical Procedures** (2008) (product no. 012558kk [paperback], WAN-XXkk [online], or DAN-XXkk [CD-ROM])
- **Audit Guide Assessing and Responding to Audit Risk In a Financial Statement Audit** (2006) (product no. 012456kk [paperback] or WRA-XXkk [online])
- **Audit Guide Audit Sampling** (2008) (product no. 012538kk [paperback], WAS-XXkk [online], or DAS-XXkk [CD-ROM])
- **Audit Guide Service Organizations: Applying SAS No. 70, as Amended** (2008) (product no. 012778kk [paperback], WSV-XXkk [online], or DSV-XXkk [CD-ROM])
- **Comprehensive Audit Risk Alert—2008** (product no. 022339kk [paperback], WGE-XXkk [online], or DGE-XXkk [CD-ROM])
- **Audit Risk Alert Compilation and Review Developments—2008** (product no. 022309kk [paperback], WCR-XXkk [online], or DCR-XXkk [CD-ROM])
- **Audit Risk Alert Independence and Ethics Developments—2008** (product no. 022479kk [paperback], WIA-XXkk [online], or DIA-XXkk [CD-ROM])
- **Audit Risk Alert Understanding the New Auditing Standards Related to Risk Assessment** (product no. 022526kk [paperback])
- **Checklists and Illustrative Financial Statements for Common Interest Realty Associations** (product no. 008909kk [paperback] or WCT-CLkk [online])
- **Audit and Accounting Manual** (2008) (product no. 005138kk [paperback], WAM-XXkk [online], or AAM-XXkk [loose leaf])
- **Accounting Trends & Techniques, 62nd Edition** (product no. 009900kk [paperback] or WAT-XXkk [online])

Additional resources for accountants in business and industry are the Financial Reporting Alert series, designed to be used by members of an entity’s financial management and audit committee to identify and understand current accounting and regulatory developments affecting the entity’s financial reporting.

- **Financial Reporting Alert Current Accounting Issues and Risks—2008** (product no. 029208kk [paperback])
- **Financial Reporting Alert Not-for-Profit Organizations—Accounting Issues and Risks—2008** (product no. 029207kk [paperback])
- **Financial Reporting Alert FASB Codification Developments—2008** (product no. 029209kk [paperback])

AICPA reSOURCE: Accounting and Auditing Literature

The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm’s needs. Or, you can sign up for access to the entire library.
Get access—anytime, anywhere—to the AICPA’s latest Professional Standards, Technical Practice Aids, Audit and Accounting Guides (more than 20), Audit Risk Alerts (more than 15), and Accounting Trends & Techniques. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Continuing Professional Education

The AICPA offers a number of CPE courses that are valuable to CPAs working in public practice and industry, including the following:

- **AICPA’s Annual Accounting and Auditing Update Workshop (2008–2009 Edition)** (product no. 736184kk [text] or 187192kk [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.

- **International Versus U.S. Accounting: What in the World is the Difference?** (product no. 731666kk [text]). With the fast pace of the convergence project, understanding the differences between IFRS and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRS and U.S. GAAP.

- **The International Financial Reporting Standards: An Overview** (product no. 157220kk [online] or 739750HSkk [DVD]). This course captures a live presentation on IFRS given to the AICPA Board of Directors.

Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

AICPA CPEExpress (formerly AICPA InfoBytes), offered exclusively through cpa2biz, is the AICPA’s flagship online learning product. AICPA members pay $180 for a new subscription and $149 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPEExpress offers hundreds of hours of learning in a wide variety of topics.

To register or learn more, visit www.cpa2biz.com.

Webcasts

Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession’s leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.

**IFRS Quarterly Webcast Series**

The IFRS Quarterly Webcast Series, brought to you each calendar quarter, is part of a multistep educational process to get practitioners, financial managers, and auditors up to speed on all aspects of IFRS implementation. Over the course of the quarterly series, IFRS standards will be covered in depth. International harmonization is quickly approaching and this series will help both accountants and auditors stay abreast of the developments and the changes they will need to implement.

**CFO Quarterly Roundtable Series**

The CFO Quarterly Roundtable Series, brought to you each calendar quarter via webcast, covers a broad array of “hot topics” that successful organizations employ and subjects that are important to the CFO’s personal success. From financial reporting, budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

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Member Service Center

.151 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.152 Do you have a complex technical question about GAAP, OCBOA, or other technical matters? If so, use the AICPA’s Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. Beginning January 14, 2008, hotline hours were extended so that the hotline is now available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/.

Ethics Hotline

.153 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA’s Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

Industry Web Sites

.154 The Internet covers a vast amount of information that may be valuable to auditors of CIRAs, including current industry trends and developments. Some of the more relevant sites for auditors with CIRA clients include those shown in the following table:

<table>
<thead>
<tr>
<th>Organization</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>Community Associations Institute (CAI)</td>
<td><a href="http://www.CAIonline.org">www.CAIonline.org</a></td>
</tr>
<tr>
<td>National Association of Housing Cooperatives (NAHC)</td>
<td><a href="http://www.coophousing.org">www.coophousing.org</a></td>
</tr>
<tr>
<td>Community Associations Network</td>
<td><a href="http://www.communityassociations.net">www.communityassociations.net</a></td>
</tr>
<tr>
<td>The National Conference on Uniform State Laws (NCCUSL)</td>
<td><a href="http://www.nccusl.org">www.nccusl.org</a></td>
</tr>
</tbody>
</table>

* * *

.155 This Audit Risk Alert replaces Common Interest Realty Associations Industry Developments—2006/07. As you encounter audit or industry issues that you believe warrant discussion in next year’s Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to dbowman@aicpa.org or write to

Doug Bowman, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

AICPA Audit and Accounting Manual AAM §8080.155
Appendix—Additional Web Resources
Here are some useful Web sites that may provide valuable information to accountants.

<table>
<thead>
<tr>
<th>Web Site Name</th>
<th>Content</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>American Institute of CPAs (AICPA)</td>
<td>Summaries of recent auditing and other professional standards as well as other AICPA activities</td>
<td><a href="http://www.aicpa.org">www.aicpa.org</a>  <a href="http://www.cpa2biz.com">www.cpa2biz.com</a>  <a href="http://www.ifrs.com">www.ifrs.com</a></td>
</tr>
<tr>
<td>AICPA Accounting Standards Executive Committee (AcSEC)</td>
<td>Issues guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards</a></td>
</tr>
<tr>
<td>AICPA Accounting and Review Services Committee (ARSC)</td>
<td>Develops and issues review and compilation standards and interpretations</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee</a></td>
</tr>
<tr>
<td>AICPA Professional Issues Task Force (PITF)</td>
<td>Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force</a></td>
</tr>
<tr>
<td>Economy.com</td>
<td>Source for analyses, data, forecasts, and information on the United States and world economies</td>
<td><a href="http://www.economy.com">www.economy.com</a></td>
</tr>
<tr>
<td>The Federal Reserve Board</td>
<td>Key interest rates</td>
<td><a href="http://www.federalreserve.gov">www.federalreserve.gov</a></td>
</tr>
<tr>
<td>Financial Accounting Standards Board (FASB)</td>
<td>Summaries of recent accounting pronouncements and other FASB activities</td>
<td><a href="http://www.fasb.org">www.fasb.org</a></td>
</tr>
<tr>
<td>USA.gov</td>
<td>Portal through which all government agencies can be accessed</td>
<td><a href="http://www.usa.gov">www.usa.gov</a></td>
</tr>
<tr>
<td>International Accounting Standards Board (IASB)</td>
<td>Summaries of International Financial Reporting Standards and International Accounting Standards</td>
<td><a href="http://www.iasb.org">www.iasb.org</a></td>
</tr>
<tr>
<td>International Auditing and Assurance Standards Board (IAASB)</td>
<td>Summaries of International Standards on Auditing</td>
<td><a href="http://www.iaasb.org">www.iaasb.org</a></td>
</tr>
<tr>
<td>International Federation of Accountants (IFAC)</td>
<td>Information on standards setting activities in the international arena</td>
<td><a href="http://www.ifac.org">www.ifac.org</a></td>
</tr>
<tr>
<td><strong>Web Site Name</strong></td>
<td><strong>Content</strong></td>
<td><strong>Web Site</strong></td>
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</tr>
<tr>
<td>Private Company Financial Reporting Committee (PCFRC)</td>
<td>Information on the initiative to further improve FASB’s standard setting process to consider needs of private companies and their constituents of financial reporting</td>
<td><a href="http://www.pcfrc.org">www.pcfrc.org</a></td>
</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
<td>Information on accounting and auditing activities of the PCAOB and other matters</td>
<td><a href="http://www.pcaob.org">www.pcaob.org</a></td>
</tr>
</tbody>
</table>

[The next page is 8247.]
AAM Section 8090

Real Estate and Construction Industry Developments—2008

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of real estate and construction entities with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an *other auditing publication*, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Keira A. Lichtenstein, CPA
Technical Manager
Accounting and Auditing Publications

Acknowledgments

The AICPA staff is grateful to Christopher Roemersma, CPA, CFE, CVA, MBA of Beers & Cutler, PLLC, for his essential contributions in creating this publication.

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your real estate and construction industry audits. It can also be used by an entity’s internal management to address areas of audit concern. The information herein can assist you in achieving a more robust understanding of the business, economic, and regulatory environment in which your clients operate. This important tool can help you identify the significant risks that may result in the material misstatement of financial statements. Moreover, it delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This alert is intended to be used in conjunction with AICPA Comprehensive Audit Risk Alert—2008 (product no. 022339kk). This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.
Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.03 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor’s understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity’s financial performance
- Internal control, which includes the selection and application of accounting policies

.04 Real estate and construction entities may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.05 The auditor should obtain an understanding of the entity’s objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity’s ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity’s business is also dynamic, and the entity’s strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.06 After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

.07 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client’s environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic and Industry Developments

The State of the Economy

.08 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on the entity’s financial statements being audited.

.09 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to 2008 third quarter advance estimates, real GDP decreased at an annual rate of 0.3...
percent, which is down significantly from the 2.8 percent increase in real GDP during the second quarter of 2008.

.10 The unemployment rate remained relatively unchanged during 2007, holding between 4.4 percent and 5.0 percent, with an annual average rate of 4.6 percent. However, during 2008, the unemployment rate has risen. As of September 2008, the unemployment rate was 6.1 percent, representing approximately 9.5 million people.

.11 The target for the federal funds rate remained stable at 5.25 percent from June 2006 to September 2007 when the Federal Reserve began decreasing rates. Since the first rate decrease in September 2007, the Federal Reserve has decreased rates a total of 4.25 percentage points to 1.0 percent as of the end of October 2008. The Federal Reserve noted in its October press release that the pace of economic activity appears to have slowed markedly, owing importantly to a decline in consumer expenditures. Business equipment spending and industrial production have weakened in recent months, and slowing economic activity in many foreign economies is damping the prospects for U.S. exports. Moreover, the intensification of financial market turmoil is likely to exert additional restraint on spending, partly by further reducing the ability of households and businesses to obtain credit. Inflation has been high, but the Federal Open Market Committee, which sets the nation’s monetary policy, believes that the decline in energy and other commodity prices and the weaker prospects for economic activity have reduced the upside risks to inflation.

Real Estate and Construction Industry Trends and Conditions

.12 As of September 2008, the real estate and construction industries in the U.S. employ approximately 9.2 million people (preliminary figures, seasonally adjusted), according to the Bureau of Labor Statistics. This is comprised of 2.1 million in the real estate industry and 7.1 million in the construction industry.

.13 According to the Bureau of Economic Analysis, the real estate and rental and leasing industry composed 12.6 percent of the country’s GDP in both 2006 and 2007; by contrast, the construction industry was 4.8 percent of the country’s GDP in 2006 and declined to 4.1 percent in 2007.

.14 Since early 2007, the decline in the residential market has sent shockwaves through the entire U.S. economy. The affected parties from the housing market downturn range from homeowners to investment banks to investors in real estate companies. Though analysts and experts disagree about whether we have hit bottom yet, the overwhelming sentiment is that a further decline is likely. According to the New York Times, from 2001 to 2007 domestic financial indebtedness grew from $8.5 trillion to $14.5 trillion, with home mortgage debt responsible for $5.1 billion (or 85 percent), increasing from $4.9 trillion to $10 trillion. In 2007, the total indebtedness was three times the size of GDP. This type of scenario has not occurred since the Great Depression. Some experts have attributed the current situation to the perfect storm of circumstances: rising home values, historically low interest rates, loosening underwriting and lending standards, unprecedented high loan to value ratios, and the notion that housing is a fail-safe investment.

.15 The combination of the state of the economy, the failures and subsequent takeovers of banks, and the actions taken by the U.S. Treasury during 2007 and 2008 is unprecedented. Real estate and construction companies have been and will continue to be affected. Some of the possible effects include counterparty default risk, concentration on liquidity, shrinking balance sheets due to asset write-downs, increased focus on recourse versus nonrecourse debt, tenant defaults leading to greater allowances for doubtful accounts and write-offs, and a general lack of opportunity for activity and investment in the marketplace.

.16 The construction industry has been strongly affected by the real estate market’s slowdown, and its negative effects are projected to continue at least through the latter half of 2009. In addition to the state of the economy, the construction industry must also face rising energy and material costs, which experts estimate will only continue to rise. In September 2008, the U.S. Census Bureau reported that the rate of seasonally adjusted annualized new single family home sales decreased 33.1 percent compared with September 2007. From December 2007 to March 2008, the amount of new home sales decreased monthly by 0.5 percent, 4.2 percent, and 10.3 percent respectively, before increasing between March and April 2008 by 5.7 percent. Sales then decreased 5.0 percent from April to May, and 3.1 percent from May to June.
third quarter of 2008, the amount of new home sales was slightly erratic by increasing 3.6 percent from June to July, decreasing 12.6 percent from July to August, and then increasing 2.6 percent from August to September.

However, select nonresidential construction segments are expected to sustain their 2007 growth through 2008. These segments include power, energy, communication, hospitals, and higher education. An additional offsetting factor to the decrease in the construction of new homes is existing-home renovations by people unable to purchase new homes in this market. Aging baby boomers who want to remain in their homes are also a growing component of the remodeling segment.

Real Estate Industry Segment Conditions

Residential Market Conditions

The real estate residential market has continued to experience challenging times, with most experts not anticipating a turnaround in the near future. According to the National Association of Realtors (NAR), the seasonally adjusted annualized rate of existing home sales increased 5.5 percent from August to September 2008; however, it rose 1.4 percent compared with September 2007. As of mid-October 2008, the number of mortgage applications decreased 26.6 percent from a month prior and 32.8 percent from the prior year’s mortgage applications. September 2008 median existing housing prices also dropped 9 percent compared with the prior year.

Option adjustable rate mortgages (ARMs) became popular during the peak of the residential real estate cycle. The defining characteristics of an option ARM include the ability to make minimum payments in the beginning that do not cover any principal and do not necessarily cover all the interest. Any unpaid interest is added to the loan balance up to a certain dollar threshold. At that point the loan is recast (that is, recalculated) as a standard amortizing principal loan. The interest rates usually increase to typical mortgage rates after the first few months. According to Credit Suisse, by April 2009 monthly option recasts will reach $5 billion and will peak around January 2010 at $10 billion. Of the option ARMs issued in 2006, approximately 13 percent were 60 days delinquent within the first 18 months of issuance. As of mid-2008, 1 million borrowers have option ARMs, and only a small number of those ARMs have been recast, which explains the overwhelming estimates for recasting in 2009 and 2010. Additionally, of the approximately $500 billion of outstanding option ARM loans, 60 percent are attributable to California homeowners.

According to RealtyTrac, a total of 265,968 foreclosures were filed in September 2008, which was 12 percent less than the number of those filed in August 2008, but 21 percent more than those filed a year earlier (in September 2007). This is equivalent to 1 out of every 475 U.S. households. Properties receiving foreclosure filings are highly concentrated in Nevada, where 1 out of every 82 households is in foreclosure, compared to Florida (1 of every 178), and California (1 out of every 189). Regions with the fastest and greatest growth during the real estate boom have also fallen the fastest and hardest during this downturn. Many mortgages in trouble are associated with homes located in affordable outskirts of expensive cities.

The causes of the residential real estate downturn are numerous, with the result being larger than the sum of its pieces due to their unique interaction. Speaking about the general real estate market, a PricewaterhouseCoopers June 2008 Global Real Estate Now article noted, “The velocity and froth that accompanied the rush to ‘do deals’ created a highly competitive environment that led both issuers and investors to act in favor of the greater greed rather than the greater good.” With rising real estate values, historically low interest rates, and abundant sources of liquidity, both banks and borrowers entered into riskier than normal mortgages. These mortgages had little to zero money down, high loan to value ratios, teaser interest rates, and decreased to nearly nonexistent scrutiny of income verification. Essentially many borrowers received mortgages they could not afford, and banks took on additional risk. After years of what some experts identified as a crisis waiting to happen, the real estate bubble burst, and the residential real estate industry is trying to pick up the pieces.
Another market greatly affected by the residential real estate downturn is the securitization market, both residential and commercial. In terms of residential, the biggest market makers of mortgage backed securities are Federal Home Loan Mortgage Corp (Freddie Mac) and Federal National Mortgage Association (Fannie Mae), both of which have implicit government backing. In the early weeks of the third quarter of 2008, concerns began to mount around the capitalization of these two government-sponsored entities (GSEs). To calm market sentiment and inject confidence into the markets, the U.S. Treasury Department and Federal Reserve Bank proposed (and subsequently passed) a bill authorizing the administration to make loans and investments in the two publically traded GSEs (including establishing a line-of-credit and purchasing stock in). In early September 2008, the U.S. Treasury Department exercised this ability and acquired $1 billion of preferred shares in each GSE and pledged to provide the GSEs up to $200 billion to weather the current real estate housing market. These preferred shares are the most senior class of equity and will therefore receive their 10 percent dividend yield first. Additionally, the U.S. Treasury, for a nominal sum, received warrants equivalent to 79.9 percent ownership in each GSE. These plans put the GSEs under a conservatorship. Their regulator, the Federal Housing Finance Agency (FHFA), will control the GSEs until it deems the entities financially healthy. The executives and board of directors of both GSEs are also being replaced. The U.S. Treasury will limit the size of each entity’s mortgage portfolios to $850 billion as of year-end 2009. Immediately following this time, the entities will decrease their mortgage portfolios by approximately 10 percent per annum until they each hold $250 billion. This has changed the perception of the two GSEs from being implicitly government backed to explicitly government backed.

Many banks are also in the business of creating securitizations—even though these securitizations are primarily built on commercial loans. Although securitization is a powerful investment tool that creates liquidity and diversification, it is a highly leveraged vehicle with complicated risks. Not all investors and banks fully understood the risks or the underlying assets (residential mortgages or commercial loans) they were investing in. The cycle perpetuated itself as mortgages were securitized, put into collateralized debt obligations (CDOs) to be securitized again, and purchased by investors. This is partly why the decline has stretched so far and affected so many businesses and investors.

As the situation evolved and delinquencies began increasing in the residential market, lenders were unable to sell the loans they had already made. In addition, the secondary market dried up with executives nervous about the quality of the assets, the riskiness of these investments, and the soundness of the financial institutions. This inhibited banks from being able to sell loans for securitizations, which reduced liquidity and lending activity even more. This is further exacerbated by defaulting homeowners and imminent foreclosures of homes that may not be worth their outstanding loan value. A survey by the Real Estate Research Corporation garnered the following information on the availability of capital: On a scale of 1 to 10 (10 being the highest), those surveyed reported their sentiment on the availability of capital of 8.7 in the first quarter of 2007, 5.5 in the fourth quarter of 2007, and 4.7 in the first quarter of 2008.

Although most experts do not believe the residential market has hit bottom yet, general sentiment is that it will come back and regain the confidence of investors as a strong investment vehicle over time.

The multifamily housing rental market has also been negatively affected by the residential real estate conditions. According to NAR, vacancy rates are expected to rise to 5.7 percent by the end of 2008, up from 4.8 percent at the end of 2007. An explanation for this trend is that the second half of 2008 will produce an increase in first time home buyers due to declining prices and the recently implemented tax credit for first time home buyers. According to CB Richard Ellis (CBRE), other factors shifting vacancy upward include job losses and supply increases. However, the increase in supply is not only from completed construction of for-rent buildings, but also from previously for sale condominiums being made available to rent. This phenomenon is only expected to increase as more condominium buildings are completed without a matching increase of demand to buy. This will continue to push vacancy rates up and encumber rent growth.

As of October 2008, 14 residential apartment Real Estate Investment Trusts (REITs) are in the FTSE National Association of Real Estate Investment Trusts (NAREIT) U.S. Equity REIT Index. As of October 2008, this subsector of the FTSE NAREIT Equity REIT Index had 1 and 3 year compounded annual total returns of –4.15 percent and 8.64 percent, respectively. When comparing these one and three year compounded
annual total returns to the other residential subsectors of the FTSE NAREIT Index, the residential apartment subsector has the best returns. The other residential subsectors include the manufactured homes subsector (1 and 3 year compounded annual total returns of –7.89 percent and 0.05 percent, respectively) and the home financing subsector (1 and 3 year compounded annual total returns of –24.84 percent and –20.58 percent, respectively). Although the positive returns of apartment REITs are not overwhelmingly high, they exhibit the lesser effects suffered by this subsector from the residential downturn.

**Office Market Conditions**

.28 The office market has been affected by the overall negative state of the economy to varying degrees. According to Colliers International, the first quarter of 2008 was the first quarter since 2003 with negative net absorption of approximately 3.7 million square feet. The second quarter of 2008 continued this trend with overall negative net absorption of 1.4 million square feet. Additionally, at the end of the first quarter of 2008, overall office vacancy increased to 12.97 percent and by the end of the second quarter of 2008 rose an additional 27 basis points to 13.24 percent. This marks the third quarterly increase in vacancy rates. Of this second quarter 2008 increase, Class A central business district vacancies rose 60 basis points to 10.17 percent, and Class A suburban vacancies rose 42 basis points to 14.26 percent. A contributing factor to the increases in vacancy rates and the negative net absorption is new office space availability, which is expected to remain at a consistently high level for the next few quarters of 2008 and into 2009.

.29 Despite those circumstances, downtown and suburban rents experienced slight increases consistent with the past two years. Weighted average annual downtown Class A rents are at $50.10 per square foot and suburban Class A rents are at $28.70 per square foot compared with $49.90 and $28.80 in the first quarter of 2008, and $48.60 and $28.68 in the fourth quarter of 2007, respectively. The cities with vacancy rates above 20 percent as of the end of the second quarter 2008 include Fairfield, Pleasanton/Walnut Creek, San Jose/Silicon Valley, and Stockton/San Joaquin County. On the other side of the spectrum are Boise and Charlotte with vacancies under 5 percent.

.30 Office investment activity has been affected more by the economy than the office rental market discussed previously. According to Real Capital Analytics, September 2008 real estate property sales volume (for properties over $5 million) is 57 percent lower than September 2007, and the cumulative year-to-date decrease through September 2008 is 77 percent. The general sentiment for all players in the real estate office market is one of hesitation due to uncertainty of the market—both its current state and future outlook. Two additional contributing factors are (1) buyers and sellers cannot agree on valuations and (2) most owners do not feel pressure to dispose of property for a price they believe to be too low. February 2008 produced the sharpest decline in commercial property prices in the last 15 years according to Standard & Poor’s.

**Industrial Market Conditions**

.31 The industrial real estate market has also not been immune to the economic downturn. The national vacancy rate increased by approximately 60 basis points to 8.52 percent, and negative net absorption equaled 9.6 million square feet in the second quarter of 2008, as opposed to 26.3 million square feet in the last quarter of 2007, according to Colliers International. A contributing factor to this statistic is considerable construction completion despite declining demand. Although these completions are expected to continue in the upcoming quarters of 2008, the amount being completed is expected to decline over the same timeframe due to the downward trend in new development activity. One slight offsetting factor is a weak dollar that has lowered the price of American products to foreigners and, therefore, increased the demand for manufacturing real estate to make these products.

.32 According to Colliers International, 2008 rents through the second quarter have remained relatively stable overall, with a modest 1.3 percent year to date decrease and a 0.8 percent decrease from first to second quarter 2008. When disaggregated by segment for year-to-date 2008 through June, stronger trends emerge with bulk space rents increasing by 11.8 percent, flexible/service space rents decreasing by 3.2 percent, and technology/research and development space rents decreasing by 9.8 percent. According to Real Capital Analytics, industrial real estate property sales volume (for properties over $5 million) has slowed during

.33 According to Colliers International, through the end of the second quarter of 2008, the industrial real estate markets with the lowest square footage of net absorption were Chicago, with negative 4.9 million; San Jose/Silicon Valley, with negative 3.98 million; and Los Angeles, with negative 3.0 million net absorption. The markets with the highest square footage of absorption were Dallas/Ft. Worth, with 5.1 million; Houston, with 3.6 million; and Central New Jersey, with 2.9 million. When analyzed in conjunction with square footage currently under construction in these markets, some consistency was lacking. Chicago, with the worst absorption for the quarter, had the third highest square footage under construction at 11.5 million square feet, which implies a continued downward trend. Additionally, Los Angeles, with the third worst net absorption, is approximately 980,000 square feet above the average amount of square feet currently under construction in a survey of 56 U.S. cities. However, San Jose/Silicon Valley had lower than average square footage currently under construction, which could help this market. The two largest markets for industrial space currently under construction at the end of the second quarter of 2008 are in line with absorption statistics: Los Angeles (Inland Empire) with 15 million and Dallas/Ft. Worth with 12 million.

Retail Market Conditions

.34 The economic slowdown and increase in gas prices have left consumers with less disposable income; therefore, they have been curtailing their retail spending. Two slightly offsetting factors include (1) the economic stimulus checks and tax refunds from the government and (2) increased tourism spending due to the weak dollar. Retailers that have been largely unaffected by the current scenario include grocery stores and general merchandisers (for example, Target) because the items they sell are considered necessities. Additionally, luxury and couture retail brands have not been greatly affected due to the high wealth level of their clientele.

.35 According to Reis, a New York based real estate research company, neighborhood and community shopping center vacancies increased by 90 basis points during the second quarter of 2008 to 8.2 percent. This is the highest vacancy rate since 1995. Regional and super regional mall vacancies increased 70 basis points during the second quarter of 2008 to 6.3 percent, the highest vacancy rate since the first quarter of 2002. In terms of retail space, neighborhood shopping centers typically have up to 150,000 square feet, community centers have between 100,000 and 350,000, regional malls between 400,000 and 800,000, and super regional malls at least 800,000 square feet. However, rents have continued to increase by nominal amounts. Neighborhood and community shopping centers experienced a 0.4 percent increase in asking rent in the second quarter of 2008 compared with 0.5 percent growth in the first quarter of 2008 and 0.8 percent growth in the second quarter of 2007. Regional and super regional malls experienced a 0.2 percent growth in rent in the second quarter of 2008, compared to 0.4 percent growth in the first quarter of 2008, and 0.9 percent in the second quarter of 2007. According to Colliers International, total national shopping center vacancies are not expected to rise past 10 percent. Retail development is led by mixed-use properties for the second year in a row, with traditional neighborhood centers second and lifestyle centers third.

.36 According to Real Capital Analytics, retail real estate property sales volume (for properties over $5 million) has slowed during 2008 with transaction volume down by 78 percent when comparing September 2008 to September 2007 and a 2008 year-to-date decline of 72 percent through September 2008. All parties are hesitant to enter into transactions given the general uncertainty about the economy.

Hospitality Market Conditions

.37 According to Lodging Econometrics, the total construction pipeline at the end of 2008’s second quarter is still strong, with an increase of 9.3 percent or 67,000 rooms over 2007’s fourth quarter for a total of 786,000 rooms in the pipeline. Construction starts increased 35 percent in 2007, and the first quarter of 2008 produced the highest amount of construction starts in the last decade. However, during the second quarter of 2008, the housing crisis affected the hospitality industry with 327 projects cancelled, the highest number since the fourth quarter of 2001 in response to the September 11th terrorist attacks. Second quarter
2008 construction project starts also declined 17 percent from first quarter 2008 to 381 projects started. However, this is still considered a normal level and approximates statistics from the third quarter of 2007. A June 2008 forecast predicts 1,218 hotel openings in 2008 and 1,508 hotel openings in 2009, with 63 percent of these rooms already under construction. Financing is becoming increasingly more difficult to source, and this is expected to result in a decline of projects in the pipeline going forward. The underlying rationale for the overall strength of the hospitality industry, in spite of the recessionary economy, is related to hoteliers’ continued ability to obtain financing albeit at tighter standards. Additionally, the hospitality industry is accustomed to the hotel business cycle of 7-11 years, which goes from downturn (which has begun), transition, and expansion.

September 2008 data released from Smith Travel Research presents the key statistics of North America’s hospitality market’s overall health. Year-to-date key industry measures show occupancy down 3.0 percent at 62.9 percent, average daily rate up 3.7 percent at $107.41, and revenue per available room up 0.6 percent at $67.58 when compared with year-to-date September 2007.

### Real Estate Investment Trusts

Interest and investment in REITs has increased dramatically from the creation of REITs in 1960, and especially over the last 10 years. According to the National Association of Real Estate Investment Trusts (NAREIT), average daily dollar trading volume has significantly increased from $413 million in July 1998 to $892 million in July 2003 to $4.6 billion in July 2008. In the first nine months of 2008, public REITs raised $16.4 billion of capital via secondary equity offerings of $11.2 billion and secondary debt offerings of $5.2 billion. Through September 2008, there have been only two initial public offerings. The table following illustrates the high and low points of REIT initial public offerings since 2002.

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of REIT Initial Public Offerings</th>
<th>Capital Raised</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>3</td>
<td>$608,000,000</td>
</tr>
<tr>
<td>2003</td>
<td>8</td>
<td>$2,646,000,000</td>
</tr>
<tr>
<td>2004</td>
<td>29</td>
<td>$7,980,000,000</td>
</tr>
<tr>
<td>2005</td>
<td>11</td>
<td>$3,789,000,000</td>
</tr>
<tr>
<td>2006</td>
<td>5</td>
<td>$2,271,000,000</td>
</tr>
<tr>
<td>2007</td>
<td>4</td>
<td>$1,820,000,000</td>
</tr>
<tr>
<td>2008 (through September)</td>
<td>2</td>
<td>$491,000,000</td>
</tr>
</tbody>
</table>

Although all types of public REITs have seen decreases in their stock prices, the FTSE NAREIT Mortgage REIT Index has experienced acutely steeper declines when compared with the FTSE NAREIT Equity REIT Index. As of September 2008, there are 19 mortgage REITs (9 home financing and 10 commercial financing) that compose the FTSE NAREIT Mortgage REIT Index. As of September 2008, this index had 1 and 3 year compounded annual total returns of –30.82 percent and –22.07 percent, respectively. When examining 1 and 3 year compounded annual total returns as of September 2008, the best performing REITs were health care specialty REITs (24.46 percent and 18.34 percent, respectively), followed by self storage REITs with (23.38 percent and 13.01 percent, respectively). The FTSE NAREIT All REIT Index price experienced a 28.31 percent gain in 2006, a 21.39 percent decrease in 2007, and a 44.38 percent decrease through mid-October 2008. Based on the state of today’s market, REITs appear poised to continue to face a challenging immediate future.
Construction Industry Conditions

Construction Put in Place

.41 Construction put in place is one of the nation’s key economic indicators as reported by the U.S. Census Bureau and represents the value of construction installed or erected at a construction site during any given period. This includes the cost of materials and labor, the contractor’s profit, costs of architects and engineers, overhead, and all interest and taxes paid. According to August 2008 statistics, on a seasonally adjusted annual rate by the U.S. Census, total construction put in place decreased 5.9 percent from August 2007. Over the same timeframe, private construction put in place decreased 10.5 percent, and public construction put in place increased 7.7 percent.

Rising Construction Sectors

.42 As noted by the Associated General Contractors of America (AGC), nonresidential construction experienced strong growth in 2007, and 2008 is expected to follow this trend. Five types of projects with strong expected spending growth include power, energy, communication, hospitals, and higher education. The power segment includes power plants, wind and solar facilities, and transmission lines. This power spending is coming from a variety of project types, including design stages, upgrades and changes on existing power facilities related to environmentally friendly power production, and experimental projects.

.43 According to AGC, the strength in construction spending on energy is primarily attributed to additions at oil refineries, onshore oil and gas development, biodiesel and renewable diesel plants, and chemical manufacturing. 2008 is expected to bring a 20 percent increase in energy construction spending. Given the tremendous growth in cellular phones and other mobile hand-held devices in addition to the increase of sound and video files transmitted electronically, construction spending on cell-phone towers and data centers are on the rise as well. This trend is expected to continue strong through 2008; however, the state of the economy could stunt this growth.

.44 The fourth expected segment of increased construction spending, according to AGC, is hospitals. Given the ever-evolving health care treatments and increased reliance on technology, hospitals need renovations to accommodate the new equipment, wiring, plumbing, and air handling equipment. Lastly, higher education is also expected to see strong growth in 2008. Many colleges with endowments or capital campaigns are using the money earned from stock market gains and appreciation on construction. These are large projects that will boast this sector’s spending for years to come.

Public & Private Construction

.45 Examining the sectors of public and private construction put in place based on data from the U.S. Census results in the emergence of different patterns. August 2008 data compared to August 2007 data showed similar total nonresidential construction increases in both the public and private sectors, as did the health care, and transportation segments. Other segments were consistently increasing or decreasing, yet they also exhibited percentage differences between the changes in public versus private sectors exceeding 10 percent. The office segment experienced 7.4 percent growth in the private sector and 24.7 percent increase in the public sector; the power segment experienced 31.1 percent growth in the private sector and only a 9.0 percent increase in the public sector. The segments that exhibited different patterns were residential construction and education construction. Compared with the same month of the prior year, August 2008 private residential construction experienced a 28.4 percent decrease, but public residential construction increased 4.2 percent, which is not unexpected given the differing market forces affecting private and public residential construction. Private and public education construction decreased 3.0 percent and increased 8.1 percent in August 2008 compared with the same month of the prior year, respectively. Lastly, in both sectors, the commercial and amusement and recreation segments decreased in August 2008 compared with August 2007.
Regarding segments exclusive to one sector, public construction showed double digit percentage increases in public safety and water supply, and private construction showed double digit increases in manufacturing and lodging. The largest decreases in each sector were residential construction in the private sector and commercial construction in the public sector.

Residential Construction

In September 2008, the U.S. Census reported the following seasonally adjusted annual statistics from September 2007 to September 2008 for new privately-owned residential construction:

- 31.1 percent decrease in new privately owned housing units started
- 17.3 percent decrease in new privately owned housing units under construction
- 20.4 percent decrease in new privately owned housing units completed

This is primarily attributed to the market attempting to correct itself from over-building during 2003–2005, estimates the chief economist at the NAR. Currently there is an over-saturation of new homes on the market and few buyers in sight. Based on population growth estimates and the number of homes demolished annually, approximately 1.6 million new homes are needed each year. During 2003–2005, roughly 1.2 million excess homes were built, which has led to the current state of substantially decreased building. It is estimated the country’s supply will balance out to the average 1.6 million new demands per year by the end of 2009, which will necessitate a sharp increase in building by 2010 to keep up with demand.

Construction Cost Trends

The inputs of construction vary widely depending on the category of construction and are measured by the Bureau of Labor Statistics through producer price indexes (PPI), which show how price changes over time. For example, according to AGC, in 2007 wood products were 14 percent of the PPI for inputs to single unit residential construction and 1 percent of the PPI for highway and street construction. From December 2003 to July 2008, the PPI for construction inputs rose 44.1 percent. This was primarily driven by the price of diesel fuel. The Energy Information Administration noted the October 27, 2008 U.S. price of on highway diesel at $3.576, an increase of $0.501 or 16.3 percent from 1 year earlier. However this is a sharp reduction from the July 2008 peak of $4.703.

Each construction input is anticipating a different trend this year. According to AGC, steel prices are expected to rise 5 percent in 2008. This is attributable to how energy intensive steel is, specifically the crude oil required to create it. The U.S. steel companies have been able to pass along these increased costs as the weak dollar and increased shipping costs inhibit a U.S. domestic purchaser from buying foreign steel. Concrete prices are expected to rise nominally by 2–4 percent. This net increase in price comprises an increase from fuel prices, decreases from less residential building, and an increased supply due to U.S. concrete producers who increased production facilities during the height of the residential real estate market in early 2006. Diverse uses of copper in construction and other products means a steady demand for it. However, the supply of copper is somewhat limited because only a few mines can extract it. Additionally, many of these mines are in countries that experience political and civil unrest, natural disasters, and power shortages. The expectation for 2008 is that the average price of copper will increase at least 10 percent over 2007 prices. Another key input for construction is gypsum, which is used primarily in wallboard and plaster. Once single family construction started declining in early 2006, the price of gypsum fell dramatically. When the residential construction market was booming, the wallboard producers struggled to keep up with demand and began creating additional plants. Now these plants are coming online and adding to the mismatch of supply and demand. Prices are expected to decrease 10 to 20 percent in 2008. When combined, the overall expectation for construction input prices is a 6–8 percent increase over 2008.

It is also important to consider the price of labor, as it typically accounts for half the cost of any given construction project according to AGC. Employment for residential construction has fallen; however, most
construction workers have been absorbed into nonresidential projects. On the whole, construction compensation and, therefore, labor costs are expected to increase to help attract workers to the industry during this shortage.

**Surety Industry Trends**

.51 The largest influence on the surety industry is the state of the economy. In the current environment of minimal residential construction, contractors from that field are flooding the nonresidential market. This has led to increased bidding, lower profit margins for contractors, and increased defaults according to the Surety Information Office. The role of surety companies in this environment becomes more important than ever.

.52 According to the Surety Information Office, 2008 should be a profitable year for surety companies because most contractors will be filling backlogged orders from the booming construction times of prior years. Also, substantial construction in the nonresidential market is expected to taper off by the end of 2010. However, increased risk is expected to surface given the projected future defaults of contractors stemming from the general state of the economy and the residential workforce entering the nonresidential market. Although many residential contractors have successfully transitioned to the nonresidential sector, a substantial portion will show their lack of experience via poor decision making, and surety companies will be forced to remedy the situation. As noted by the Surety Information Office, “New entrants may miss costs that lead to change order requests. Substandard performance may surface. The contractor may be inadequately financed. Experience may be lacking for the scope of work they are attempting. Access to qualified labor may not be available. Material and resource suppliers may not have experience with the new player, leading to material scarcity and difficulty in locking down prices. Additionally, banking relationships may not exist to cover payment terms on larger, or public, projects.”

.53 Surety companies employ long-term management strategies, which may position them well for potential upcoming losses given the success they experienced during the real estate boom of prior years.

**Going Green**

.54 As demands for social responsibility continue to evolve, so does the increase in construction of environmentally friendly, or *green*, buildings. According to the U.S. Green Building Council, buildings are responsible for 38 percent of carbon dioxide emissions, 71 percent of electricity consumption, 39 percent of energy use, 12 percent of water consumption, and 40 percent of nonindustrial waste. This explains the strong push to make them green.

.55 Other contributing factors to the current and projected increase of green buildings include regulatory mandates, government incentives, and recent studies proving the valuable rewards to be gained. This surge in growth has necessitated the emergence of the Leadership in Energy and Environmental Design (LEED) Green Building Rating System. LEED is a third-party certification that designates a building as environmentally responsible, profitable, and a healthy place to live and work. According to Rosenberg Real Estate Equity Funds (RREEF), a business of Deutsche Bank’s Asset Management Division, many cities are even beginning to include LEED standards in their building codes. One of the strongest selling points, financially speaking, of being green is the savings on utility bills. Studies have shown a green building uses an average 30 percent less energy than a conventional building. Additionally, studies show design features of green buildings promote happier, more productive, and healthier workers. This type of data has and will continue to create demand for green buildings.

.56 According to RREEF, the premium for constructing a green building as opposed to a traditional building is nominal if planned properly. Additionally, the numerous incentives for building green more than offset any increase in building costs. Renovating traditional buildings to be green is not as straight-forward regarding the net benefit, given the diversity of characteristics of existing buildings. LEED construction has grown at a compound average rate of 50 percent per annum over the past 3 years and is expected to do so for the next few years. Lastly, government incentives for building green are expected to be replaced by requirements in the upcoming years.
Legislative and Regulatory Developments

Commercial Real Estate Loans

.57 A commercial real estate loan is categorized as a loan to buy an office building or a retail center. It also includes construction loans, land development, and other land loans irrespective of what will be built (even residential construction). These types of commercial loans were securitized in the same fashion as residential mortgages and with the same ferocity. In mid-2007 subprime residential loans started making headlines, and rating agencies announced that underwriting standards of commercial loans had also loosened. Executives started examining what they held in their portfolios and began demanding higher risk premiums for commercial mortgage backed securities (CMBS), which forced the CMBS market to a standstill. However, where the commercial market differs from the residential market is delinquencies. Through the first quarter of 2008, the Fitch U.S. CMBS Loan Delinquency Index was hovering around an all time low. At the beginning of 2008 the index was at 27 basis points and increased to 33 basis points by the end of 2008’s first quarter and to 45 basis points by the end of September 2008. It almost seemed as if the commercial market was guilty by association. According to the Commercial Mortgage Securities Association, in the first 3 quarters of 2008, there were $12.1 billion CMBS issuances compared with $196.9 billion and $130.2 billion for the same time periods of 2007 and 2006, respectively.

.58 However, as 2008 continues, the commercial market is slowly exhibiting signs of defaults and delinquencies, which is expected to continue. Fitch Ratings expects default rates on the collateral behind CMBS to increase towards 80 basis points, which approximates the historical average. Overall, commercial real estate loan performance is also expected to worsen over 2008, particularly due to the drop in residential construction loans. Spreads on CMBS have increased dramatically in recent periods causing sharp decreases in value. For example, according to Commercial Mortgage Securities Association (CMSA), spreads on AAA-rated 10 year CMBS over swaps has increased approximately 250 basis points from 2007 year end to over 300 by September 2008. It is believed that the market based valuations of CMBS do not accurately reflect the underlying strong fundamentals of the commercial real estate market. Fitch Ratings noted, “The recent valuation declines in the CMBS market imply near-catastrophic credit conditions. We do not expect such a severe decline in the credit quality of commercial real estate loans and CMBS-related assets.”

Proposed Taxation Changes

.59 If passed, there are two bills that would greatly affect real estate private equity and hedge fund companies and publicly traded partnerships. Both bills would change how these types of entities would be taxed with a result of greater income tax expense. These bills could change legal structures of new and existing entities in addition to dissuading entities from going public or even causing an entity to delist from an exchange.

.60 The key measure of the first bill, which was approved in June 2008 by the House of Representatives, would be an increase in taxes on private equity firms and hedge fund managers. This increase, along with the other tax increases proposed in the bill, is why the bill is expected to be rejected by republicans in the Senate. The bill proposes to tax the income from carried interest of private equity and hedge fund investment managers at the ordinary rate of 35 percent, as opposed to the 15 percent being paid now given the capital gain classification. The notion of changing the tax rate started gaining press after private equity and hedge fund companies started going public in early 2007.

.61 The second bill was introduced to the Senate in June 2007 and would tax publicly traded partnerships that directly or indirectly earn income as an investment advisor or asset manager as corporations. This would change the tax rate from 15 percent to 35 percent. By introducing this bill, some experts say the initial goal of greater transparency of these types of entities is completely negated because they will be dissuaded from going public. If enacted, the transition period would delay the application of this law for five years.
Withholding Tax on Government Contracts

.62 Starting January 1, 2011, a new law will require federal, state, and local governments to withhold 3 percent from all payments for goods and services as a guard against possible business tax evasion. This far-reaching new requirement was inserted as a last minute revenue raiser into the Tax Reconciliation Act of 2005 that was signed by the president in May 2006 and will affect other industries as well. The law applies to all government payments for products and services made by any federal, state, or local government that has total annual contracts of at least $100 million. A number of construction related organizations are working to have this section of the Tax Reconciliation Act of 2005 repealed.

.63 A key consideration of the repeal contingency is that the 3 percent withholding tax would be on the total contract, as opposed to the true taxable income at the end of the construction project, which is only the profit. This essentially creates a cash flow timing issue that could result in cash flow deficiencies when the construction company pays the government too much in tax upfront and receives it back from the government months later. This is problematic given the nominal margins in the construction industry, which rarely meet or exceed 3 percent according to the AGC.

.64 For example, if a small business contractor holds one government contract estimated to be completed in one year for $10 million, this law requires withholding of $300,000 on that contract. Meanwhile, the contractor expects to net approximately 2.5 percent, or $250,000, after paying for supplies, services, subcontractors, and other ordinary business expenses. The tax on the revenue generated is at most 35 percent, which means the maximum tax owed on the $10 million project is $87,500 (35 percent of $250,000). Ultimately, the government has withheld $300,000 for $87,500 in tax liability.

.65 Additionally, surety companies review cash flow when deciding whether or not to insure a contract. This withholding will force the surety companies to charge higher rates for their coverage, which will hurt the construction industry even more. The Withholding Tax Relief Act of 2007 was introduced in March 2007 to repeal this withholding tax, but no further action has been taken at the time of this writing.

Government Intervention

.66 Due to the gravity of the situation affecting the U.S. economy, on October 3, 2008, Congress passed and the president immediately signed the Emergency Economic Stabilization Act. As stated in section 2 of the bill, it “Provides authority to the Treasury Secretary to restore liquidity and stability to the U.S. financial system and to ensure the economic well-being of Americans.” Primary components of this bill include (a) an allocation of $700 billion to stabilize the U.S. financial system; (b) creation of an oversight board, executive compensation rules, and other corporate governance rules for any entities that participate; (c) increase of the statutory limit on public debt from $10.0 trillion to $11.3 trillion; (d) temporary increase of Federal Deposit Insurance Corporation (FDIC) insurance limits; (e) restatement of the Securities and Exchange Commission’s (SEC’s) authority to suspend the application of Financial Accounting Standards Board (FASB) Statement No. 157, Fair Value Measurements; and (f) the requirement of the SEC to conduct a study on the impact and effects of FASB Statement No. 157.

.67 The complete effects of this bill will take time to be felt throughout the economy, though the hope is for an increase in market sentiment soon after its placement into legislation. Less than two weeks after this bill was signed into law, the U.S. Treasury announced a proposal to buy preferred equity stakes in numerous financial institutions and thereby inject cash into the credit markets of up to $250 billion. The varying methods the U.S. Treasury will employ to achieve the goal of the Economic Stabilization Act will be seen in the coming months and years.

.68 Additionally, there are several initiatives currently offered and in the pipeline to help homeowners at risk of foreclosure. On July 30, 2008, the president signed a housing bill with numerous key components. The first group of provisions is related to the two GSE’s liquidity concerns. Through the end of 2009, both GSEs will be provided an unlimited line of credit from the Treasury, and the Treasury is authorized to purchase stock in both entities, which occurred in September 2008. Both entities also have an increased...
maximum loan limit and will be required to make annual contributions to a fund used to finance rental units for certain low income families. Lastly, the FHFA was created to supervise both GSEs (and control them under conservatorship until they are financially sound) and the Federal Home Loan Bank System. An example of the supervision measures is that the FHFA will apply corporate governance provisions of the Sarbanes-Oxley Act being to the GSEs. These include the certification of financial statements, codes of ethics, loan prohibitions, and independent audit committees. Secondly, the Federal Housing Administration (FHA) is authorized to guarantee up to $300 billion of new 30 year fixed rate loans to enable borrowers to refinance existing troubled loans. Due to the restrictive qualifications needed to refinance a loan under this program, the Congressional Budget Office estimates that approximately 400,000 homes will be able to participate in this refinancing program, and only $68 billion (of the $300 billion) will actually be used. Any involved lenders must agree to take a sizeable loss by reducing the principal of the loan balance before any refinancing can occur. Third, a tax credit of $7,500 would be created for first time homeowners in an attempt to stimulate housing demand. The tax credit essentially functions as an interest free loan that the homeowner must repay over 15 years. Lastly, the bill would provide $3.9 billion of emergency assistance aid to the hardest economically hit areas of the country.

.69 Some measures in place before the previously referenced bill was passed include FHA Secure and Hope Now. FHA Secure enables homeowners with non-FHA adjustable rate mortgages to refinance into an FHA insured mortgage, subject to certain restrictions. Another initiative, formed at the encouragement of the Department of Treasury, is Hope Now, which is an alliance between credit counselors, homeowners, counselors, mortgage servicers, and mortgage market participants. The alliance reaches out to homeowners to help them keep up with their mortgage payments to prevent foreclosures.

Audit and Attestation Issues and Developments

Audit Risks Arising From Current Economic Conditions

.70 As mentioned previously in the “Government Intervention” section, in September 2008, unprecedented events occurred in the financial markets, including the failure of a major investment bank, the acquisition of several investment and commercial banks (including some that required assistance from federal agencies), and the placement into conservatorship of Fannie Mae and Freddie Mac. Further, several foreign financial institutions received assistance from their national governments or entered into similar acquisition agreements. Additionally, on September 17, 2008, a significant publicly registered money market fund declined below the industry standard of $1.00 per share on a market value basis due to a combination of holdings of short-term securities issued by the failed investment bank and major shareholder redemptions. As a result of these events, the condition of the fixed income markets worsened. Almost overnight, corporations and financial institutions generally recognized as creditworthy began experiencing difficulty borrowing money in the financial markets. The Emergency Economic Stabilization Act was the response to these events.

.71 Generally, many fixed income markets became extraordinarily illiquid in late September 2008, resulting in a substantial increase in risk over the valuation assertion for virtually any kind of fixed income security of any duration. Concerns about the possibility of significant redemptions from various types of funds grew, and reports of certain private funds either placing limits on redemptions, freezing the ability to redeem entirely, or determining to commence an orderly wind-down of operations began circulating. Thus, subsequent events reporting considerations and assessment of some entities’ “going concern” status take on added importance in the current environment.

.72 AICPA staff has issued a new nonauthoritative Technical Practice Aid (TPA) Technical Questions and Answers (TIS) section 1100.15, “Liquidity Restrictions” (AICPA, Technical Practice Aids). It addresses the potential accounting and auditing implications when a fund or its trustee imposes restrictions on a nongovernmental entity’s ability to withdraw its balance in a money market fund or other short-term investment vehicle. The TPA covers balance sheet classification, disclosures, debt covenants, subsequent events, and going concern considerations, among other things. The TPA can be found at www.aicpa.org/download/acctstd/TIS1100_15.pdf.
Recent economic conditions may cause additional risk factors that had not existed or did not have a material effect on audit clients in prior years. When obtaining an understanding of the external factors that affect the entity and the risks associated with those factors, the auditor may consider whether conditions exist that indicate risks of material misstatement. Some examples that relate to economic conditions are as follows:

- Constraints on the availability of capital and credit
- Increased costs for materials leading to higher overhead and costs of goods sold
- Going concern and liquidity issues
- Marginally achieving explicitly stated strategic objectives
- Reduced demand for construction, residential real estate, and commercial real estate
- Declining property values
- Use of off-balance-sheet financings, special-purpose entities, and other complex financing arrangements
- Volatile real estate markets and the credit crisis, which result in significant measurement uncertainty, including accounting estimates and fair value measurements
- Changes in the entity’s supply chain, including surcharges on transportation
- Operations that are exposed to volatile markets, which may include oil or currency markets

Although many of these risks are not new to business, consideration of the many ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks.

**Consideration of an Entity’s Ability to Continue as a Going Concern**

The consideration of an entity’s ability to continue as a going concern is required in every audit performed under generally accepted auditing standards (GAAS), and is an especially important consideration in the current state of the residential market and the overall economy. It is important to note the time frame for this consideration is one year beyond the date of the financial statements. If the auditor believes there is a substantial doubt on the entity’s ability to continue as a going concern, the next steps are to obtain management’s plans to mitigate the effect of such conditions and then assess the likelihood these plans can be effectively implemented.

Some examples of indicators that there could be substantial doubt about the ability of the entity to continue as a going concern include, but are not limited to, the following:

- Negative trends such as negative cash flows from operating activities, recurring operating losses, or working capital deficiencies (for example, less than 5–10 percent of a construction contract amount) or lack of the ability to obtain additional financing
- Other indications of financial difficulties such as defaults on debt, debt covenants, or both; arrearages in dividends; the need to seek new sources of financing; denial of surety credit or usual trade credit; or the disposal of substantial assets
- Inadequate capitalization, which could inhibit general operations of a construction contractor
- Internal matters such as turnover in key management positions like CEO, CFO, controller, and project manager, or substantial dependence on the success of a particular investment or project
- Entrance into a new market for which the entity might not have the required expertise to successfully compete (for example, new types of projects, new investment strategy, or new geographic areas)
- External matters such as legal matters or market conditions
Increase in job size or number of jobs for construction contractors, which necessitates greater management skills due to the inherent increased complexities.

.77 If an auditor determines there is a substantial doubt about an entity’s ability to continue as a going concern, the auditor should communicate with those charged with governance of the entity in accordance with AU section 341, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern (AICPA, Professional Standards, vol. 1). AU section 341 provides guidance to an auditor with respect to evaluating whether there is substantial doubt about an entity’s ability to continue as a going concern and what the auditor should do when a going concern exists.

Using the Work of a Specialist

.78 It may be necessary to use a specialist (such as a real estate appraiser, securities valuation expert, or construction engineer) to assist in auditing complex or subjective matters during the audit. Examples of matters where an auditor may engage a specialist are valuation issues, reasonableness determination of amounts derived from specialized techniques or models, assistance in construction job site visits, or implementation of technical requirements, regulations, or legal documents. AU section 336, Using the Work of a Specialist (AICPA, Professional Standards, vol. 1) provides guidance to auditors in using specialists. The guidance in AU section 336 is applicable when the specialist is hired by management or if the auditor engages the specialist. However, if a specialist employed by the auditor’s firm participates in the audit, AU section 311, Planning and Supervision (AICPA, Professional Standards, vol. 1) is applicable rather than AU section 336.

.79 When using the work of a specialist, the auditor should evaluate the specialist’s professional qualifications, obtain an understanding of the nature of the work performed or to be performed, and evaluate the relationship of the specialist to the client in terms of objectivity. Although the appropriateness and reasonableness of the methods and assumptions employed by the specialist are his or her responsibility, the auditor should obtain an understanding of these qualities, test the underlying data provided to the specialist, and evaluate the specialist’s findings in the context of the audit and related assertions in the financial statements.

Real Estate Audit and Attestation Issues and Developments

Auditing Fair Value Measurements

.80 Particular assets, liabilities, and components of equity are measured or disclosed at fair value in the financial statements. It is management’s responsibility to make the fair value measurements and disclosures. When auditing these fair values to ensure they are in conformity with generally accepted accounting principles (GAAP), auditors should consult AU section 328, Auditing Fair Value Measurements and Disclosures (AICPA, Professional Standards, vol. 1), which establishes standards and provides guidance for auditors. Specific types of fair value measurements are not covered by AU section 328. For example, when auditing the fair value of derivatives and securities, refer to AU section 332, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities (AICPA, Professional Standards, vol. 1).

.81 The strongest audit evidence to support a fair value is an observable market price in an active market. If that is not available, a valuation method should incorporate common market assumptions. If common market assumptions are not available or require significant adjustments, the entity may use its own assumptions. The auditor should obtain an understanding of the entity’s process for determining fair values, as well as whether the fair value measurements and disclosures are in accordance with GAAP. During this testing, the auditor may also identify any possible indicators of impairment. According to paragraph .23 of AU section 328, “[S]ubstantive tests of the fair value measurements may involve (a) testing management’s significant assumptions, the valuation model, and the underlying data, (b) developing independent fair value estimates for corroborative purposes, or (c) reviewing subsequent events and transactions.”
.82 According to paragraph .48 of AU section 328, the auditor ordinarily should add language to the letter of representations from management regarding the reasonableness of significant underlying assumptions. When significant assumptions are used or they are highly subjective, and the items being measured at fair value are material, the auditor considers discussing these items with those charged with governance of the entity.

*Fair Values of Securities*

.83 The guidance in AU section 332 relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, there are some items of note for the auditor. As noted previously, quoted market prices in active markets are the best available audit evidence to support a fair value. However, when they are unavailable and the valuations of securities are obtained from a broker-dealer or another third party source based on valuation models, the auditor should understand the underlying valuation method used (such as a cash flow projection). The auditor may also determine it is necessary to obtain quotes from more than one pricing source based on circumstances such as an existing relationship between the entity and the valuing entity, which could inhibit objective pricing or underlying valuation assumptions that are highly subjective. In the context of FASB Statement No. 157, quoted prices in active markets are considered level 1 inputs.

.84 When an entity performs its own valuation, value testing procedures to be taken by the auditor include assessing the reasonableness and appropriateness of the model, calculating the value using his or her own model, and comparing the fair value with subsequent or recent transactions. Whether the inputs to the entities’ valuation model are observable or not determines their characterization as level 2 or level 3 inputs, respectively, within FASB Statement No. 157. When there is extensive judgment, consider using a specialist or refer to AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1). Additionally, when the underlying collateral of a security significantly contributes to its fair value and collectability of the security, evidence of the collateral should also be examined for existence, fair value, transferability, and the investor’s right to the collateral.

.85 The auditor should also evaluate management’s conclusions regarding other than temporary impairment on its securities. Examples of factors that could cause an other than temporary impairment per paragraph .47 of AU section 332 include the following:

- “Fair value is significantly below cost and—
  - The decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
  - The decline has existed for an extended period of time.
  - Management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
- The security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
- The entity recorded losses from the security subsequent to the end of the reporting period.”

Additional factors to consider when determining whether a security is other than temporarily impaired, as described in the September 30, 2008, press release by the SEC Office of the Chief Accountant and FASB Staff on Clarifications on Fair Value Accounting (SEC and FASB Press Release), include “length of time and the extent to which the market value has been less than cost; the financial condition of the issuer; and ... the intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.” The classification of an entity’s securities is based on management’s intent and ability. The auditor should obtain an understanding of management’s classification process between trading, available-for-sale, or held-to-maturity, as well as consider the classifications in light of the entity’s current financial position.
Construction Audit and Attestation Issues and Developments

Auditing Construction Contracts

.86 The accounting guidance for construction companies is contained in Accounting Statement of Position (SOP) 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts (AICPA, Technical Practice Aids, ACC sec. 10,330), which is described and interpreted in the AICPA Audit and Accounting Guide Construction Contractors. Another useful construction auditor tool is the AICPA’s Practice Alert (PA) No. 00-3, Auditing Construction Contracts (AICPA, Technical Practice Aids, PA sec. 16,170).

.87 The estimates and assumptions used by the construction contractors are primary focuses of construction company audits. The financial statements are based upon these estimates for each contract in place, given the prominence of the percentage-of-completion accounting method used in the industry. External circumstances in any given year and the area of the country in which the construction entity operates may also affect the auditor’s procedures.

.88 Another significant characteristic particular to the construction industry is the way contracts are won and paid out. A contractor normally bids to win a construction project, and within that bid are the expected costs to complete the project plus the desired profit margin, although this initial price might be renegotiated as the project progresses. Additionally, customers will often hold back a certain percentage of the overall fee until the project is completed and they are satisfied with the end product. This is known as retainage, and it is specified in the construction contract. As the project term increases, so does the risk for error in the original estimates to complete.

.89 According to Practice Alert No. 00-3, auditors should consider selecting any significant or unique contracts for testing. An example of a unique contract would be one where the company is constructing a product outside of its area of expertise. Whether the company can estimate their costs accurately enough to warrant using the percentage-of-completion method for revenue recognition is an important consideration in this instance. Other audit procedures that should be considered specific to the construction industry include understanding the process for managing cash flow during the project, confirming the contract terms plus the billing procedures, visiting construction sites, meeting with project managers, and reviewing the aging of receivables with the related collections.

.90 During audit procedures, it is important to ensure that any incurred losses are recorded immediately. An entity may try to shift costs from an unprofitable contract to a profitable one in an effort to defer losses. A prime situation for this behavior might be when the contractor underbids a project by more than 5–10 percent compared with other bids. Typically the balance sheet result of cost shifting is that underbillings (costs and estimated billings in excess of billings) increase and overbillings (billings in excess of costs and estimated earnings) decrease. Audit procedures to address this issue include:

- testing internal controls over cost coding function,
- performing substantive job cost testing for accuracy,
- comparing actual job costs to original bid documents,
- testing any revised profitability estimates to original bid documents,
- testing subsequent activity by comparison to receivables and estimates at the balance sheet date,
- reviewing allocation of indirect job costs, and
- performing analytics across projects for consistency of specific job cost components (typically 25 percent of total direct costs).

.91 The four main types of construction contracts are fixed-price, unit-price, cost-type, and time-and-materials. The set fee in a fixed-price contract scenario creates a high level of risk for both the contractor and the auditor. To allay the auditor’s fears, he or she can employ the procedures noted earlier, along with estimation procedures discussed in the aforementioned section.
When an auditor reviews loan documents, an important step is to note any loan covenants and the consequences if a covenant is violated. If the violation changes the maturity date of the loan, it is important to ensure the debt is classified correctly as current or noncurrent on the balance sheet. Another consequence to consider is if the violation affects other loans with the same lending institution and the result of that violation on each lending scenario. Given the possible tight cash flow situations of a construction company, a loan violation could devastate the economic health of a project or an entire entity.

The last key items to consider are change orders (approved and unapproved), which carry a fair amount of audit risk. Change orders are common occurrences during the construction project and can change both the scope and price of the work. Change orders must be signed to be executable. When a change order is approved as to the scope of work but not price, it may only be included in the total contract estimate after careful evaluation of all relevant facts and circumstances. However, change orders that are unapproved or in dispute should be evaluated as claims. According to Practice Alert No. 00-3, “If there is no verifiable evidence to support the recognition of revenue on an unapproved change order or claim, it should not be recognized.”

**Auditing Construction Estimates**

The first step in auditing construction estimates is to identify each occurrence and determine which are significant to the overall costs to complete and therefore revenue recognized. When evaluating accounting estimates, the auditor should consider, with an attitude of professional skepticism, both the subjective and objective factors. As discussed in paragraph .09 of AU section 342, key factors and assumptions the auditor normally concentrates on include which estimates are sensitive to variation, deviate from historical patterns, or are particularly subjective and susceptible to misstatement and bias. However, it is important to consider whether historical patterns are still applicable. For example, in a new type of project or in a slow market, new patterns may emerge.

A useful exercise when testing estimates is to obtain an up-to-date cost to complete and compare to estimates used as of the financial statement date. An auditor may analyze completed contracts to both understand the historic trends of the entity and to help identify areas where the entity has incorrectly estimated in the past. This information can help guide an auditor.

The auditor should obtain an understanding of how management develops estimates and should employ one of the approaches in testing that process as outlined in AU section 342 paragraph .10. In reviewing and testing management’s process the auditor may consider identifying controls around this process and determining if the underlying data used for the estimate are reliable and used appropriately. An auditor may develop an estimate and compare it to management’s or even look to subsequent events. For further details on auditing estimates, see AU section 342.

**Fair Value of Retention Receivables and Payables**

As noted in the general discussions of FASB Statement No. 157 and No. 159, The Fair Value Option for Financial Assets and Financial Liabilities—including an amendment of FASB Statement No. 115, an entity now has the ability to choose to measure many financial instruments and certain other items at fair value on an instrument-by-instrument basis and by using a detailed framework to determine fair value. Based on the definitions of a financial asset and financial liability in paragraph 6 of FASB Statement No. 159, retention receivables and payables in construction contracts qualify as such.

The application of these standards could allow a contractor to fair value select retention receivables and payables and record any related loss or income, respectively. As previously noted, AU section 328 establishes standards and provides guidance for auditors around auditing fair value measurements. Because these types of fair value measurements are based on management assumptions, they are inherently imprecise. The auditor’s knowledge of business and industry can help evaluate the accounting for these assets and liabilities requiring fair value measurements. According to AU section 328, “The auditor should evaluate management’s intent to carry out specific courses of action where intent is relevant to the use of
fair value measurements... The auditor should also evaluate management’s ability to carry out those courses of action.” Some examples of ways for the auditor to corroborate management’s intent and ability from AU section 328 include

- considering management’s history of carrying out its stated intentions with respect to assets or liabilities;
- reviewing written plans and other documentation, including, where applicable, budgets, minutes, and other related items;
- considering management’s stated reasons for choosing a particular course of action; and
- considering management’s ability to carry out a particular course of action given the entity’s economic circumstances, including the implications of its contractual commitments.

Auditors are encouraged to read the aforementioned FASB statements and AU section 328 to ensure they have addressed all risks associated with measuring fair value.

Summary of Recent Auditing and Attestation Pronouncements and Related Guidance

.100 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. This alert is intended to be used in conjunction with AICPA Comprehensive Audit Risk Alert—2008 (product no. 022339kk); therefore, only industry specific pronouncements and related guidance or those of specific significance to the industry are summarized herein. For information on auditing and attestation standards issued subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the CPA Letter, Journal of Accountancy, and in the quarterly electronic newsletter In Our Opinion, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

.101 The Public Company Accounting Oversight Board (PCAOB) establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review AICPA Audit Risk Alert SEC and PCAOB Developments—2008 (product no. 022499kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by visiting www.cpa2biz.com.

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<tr>
<th>Recent Auditing and Attestation Pronouncements and Related Guidance</th>
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<tbody>
<tr>
<td>Statement on Auditing Standards (SAS) No. 115, Communicating Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, vol. 1, AU sec. 325)</td>
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<tr>
<td>Issue Date: October 2008 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])</td>
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### Recent Auditing and Attestation Pronouncements and Related Guidance

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<th>Pronouncement</th>
<th>Description</th>
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| **SAS No. 114, The Auditor’s Communication With Those Charged With Governance** *(AICPA, Professional Standards, vol. 1, AU sec. 380)*  
Issue Date: December 2006  
(Applicable to audits conducted in accordance with GAAS) | Replacing SAS No. 61, *Communication With Audit Committees*, this standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, to whom they should be communicated, and the form and timing of the communication. It is effective for audits of financial statements for periods beginning on or after December 15, 2006. |
| **SAS No. 113, Omnibus Statement on Auditing Standards—2006** *(AICPA, Professional Standards, vol. 1)*  
Issue Date: November 2006  
(Applicable to audits conducted in accordance with GAAS) | This standard does the following:  
- Revises the terminology used in the 10 standards of AU section 150, *Generally Accepted Auditing Standards*, to reflect terminology in AU section 120, *Defining Professional Requirements in Statements on Auditing Standards* *(AICPA, Professional Standards, vol. 1)*.  
- Adds a footnote to the headings before paragraphs .35 and .46 in AU section 316, *Consideration of Fraud in a Financial Statement Audit* *(AICPA, Professional Standards, vol. 1)*, to provide a clear link between the auditor’s consideration of fraud and the auditor’s assessment of risk and the auditor’s procedures in response to those assessed risks.  
- Replaces throughout the SASs the term *completion of fieldwork* with the term *date of the auditor’s report*.  
- Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor’s report. |
| **SAS Nos. 104–111, the risk assessment standards**  
Issue Date: March 2006  
(Applicable to audits conducted in accordance with GAAS) | The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits; focusing on identifying and assessing the risks of material misstatements; further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels; and improving the linkage between the risks, controls, audit procedures, and conclusions. These eight SASs became effective for audits of financial statements for periods beginning on or after December 15, 2006. |
Issue Date: October 2008 | This statement establishes requirements and provides guidance that applies when a practitioner is engaged to perform an examination of the design and operating effectiveness of an entity’s internal control over financial reporting (examination of internal control) that is integrated with an audit of financial statements (integrated audit). This SSAE is effective for integrated audits for periods ending on or after December 15, 2008. Earlier implementation is permitted. |

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<tr>
<td><strong>SSAE No. 14, SSAE Hierarchy</strong> <em>(AICPA, Professional Standards, vol. 1, AT sec. 50)</em></td>
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<td>Issue Date: November 2006</td>
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<td>This standard identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in AT section 20, <em>Defining Professional Requirements in Statements on Standards for Attestation Engagements</em> <em>(AICPA, Professional Standards, vol. 1)</em>. It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.</td>
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| Issue Date: March 2002 |
| Revised Date: May 2008  |
| (Interpretive publication) |
| This auditing interpretation interprets AU section 508 and addresses the application of AU section 508 in reporting on financial statements prepared in conformity with International Financial Reporting Standards (IFRS). |

| Issue Date: May 2008 |
| (Interpretive publication) |
| This auditing interpretation interprets AU section 508 and addresses the application of AU section 508 in reporting on financial statements prepared in conformity with IFRS. |

| Issue Date: May 2008 |
| (Interpretive publication) |
| This auditing interpretation interprets AU section 534 and addresses the application of AU section 534 in reporting on financial statements prepared in conformity with IFRS. |
### Recent Auditing and Attestation Pronouncements and Related Guidance

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<td>Issue Date: May 2008 (Interpretive publication)</td>
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<tr>
<td>Statement of Position (SOP) 07–2, Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisers, or Other Service Providers (AICPA, Technical Practice Aids, AUD sec. 14,430)</td>
<td>This statement addresses the application of SSAEs primarily to examination engagements in which a practitioner reports on the suitability of the design and operating effectiveness of a service provider’s controls in achieving specified compliance control objectives. Examples of the service providers addressed by this SOP are investment advisers, custodians, transfer agents, administrators, and principal underwriters that provide services to investment companies, investment advisers, or other service providers.</td>
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<td>Issue Date: October 2007 (Interpretive publication)</td>
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<td>AICPA Technical Practice Aid (TPA) Technical Questions and Answers (TIS) sections 1100.15, “Liquidity Restrictions” (AICPA, Technical Practice Aids)</td>
<td>This question and answer discusses auditing and accounting issues related to withdrawal restrictions placed on short-term investments by a money market fund or its trustee.</td>
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<td>Issue Date: October 2008 (Nonauthoritative)</td>
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| TIS sections 8200.05–.16 (AICPA, Technical Practice Aids) | These questions and answers in TIS section 8200, “Internal Control,” were developed in response to common questions received from members regarding the implementation of SAS Nos. 104–111. Some of the topics include  
  • consideration of internal controls that are less formal or not documented by the client;  
  • whether the auditor may suggest improvements to a client’s internal control;  
  • assessing inherent risk in relation to the consideration of control risk;  
  • the frequency of walkthroughs that are used as the basis for the auditor’s understanding of internal control;  
  • considerations in obtaining an understanding of, evaluating, and documenting controls that the auditor believes are nonexistent or ineffective;  
  • assessing control risk at the maximum level; and  
  • considerations for developing a substantive audit strategy.  
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| **TIS section 9120.08, “Part of an Audit Performed in Accordance With International Standards on Auditing”** (AICPA, Technical Practice Aids)  
  Issue Date: April 2008  
  (Nonauthoritative) | This question and answer discusses the implications to the principal auditor’s report when part of an audit is conducted by other independent auditors in accordance with International Standards on Auditing or another country’s auditing standards. |
| **TIS section 9100.06, “The Effect of Obtaining the Management Representation Letter on Dating the Auditor’s Report”** (AICPA, Technical Practice Aids)  
  Issue Date: May 2007  
  (Nonauthoritative) | This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor’s report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor’s report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that it will sign the representation letter, without exception, on or before the date of the representations. |
| **TIS section 8350.01, “Current Year Audit Documentation Contained in the Permanent File”** (AICPA, Technical Practice Aids)  
  Issue Date: May 2007  
  (Nonauthoritative) | This question and answer discusses whether the provisions of AU section 339, Audit Documentation (AICPA, Professional Standards, vol. 1), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that AU section 339 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year’s audit report. |
| **AICPA Professional Issues Task Force (PITF) Practice Alert (PA) No. 03-1, Audit Confirmations** (AICPA, Technical Practice Aids, PA sec. 16,240)  
  Revised: June 2007  
  (Nonauthoritative) | This practice alert is a response to practitioners’ current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics. |
| **AICPA PITF PA No. 07-1, Dating of the Auditor’s Report and Related Practical Guidance** (AICPA, Technical Practice Aids, PA sec. 16,290)  
  Issue Date: January 2007  
  (Nonauthoritative) | This practice alert provides guidance regarding application of certain provisions of AU section 339, primarily related to dating the auditor’s report. |
| **Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 6, Evaluating Consistency of Financial Statements** (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)  
  Issue Date: November 15, 2008  
  (Applicable to audits conducted in accordance with PCAOB standards) | This standard and its related amendments update the auditor’s responsibilities to evaluate and report on the consistency of a company’s financial statements and align the auditor’s responsibilities with Financial Accounting Standards Board (FASB) Statement No. 154, Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3. This standard also improves the auditor reporting requirements by clarifying that the auditor’s report should indicate whether an adjustment to previously issued financial statements results from a change in accounting principles or the correction of a misstatement. |
<table>
<thead>
<tr>
<th>Recent Auditing and Attestation Pronouncements and Related Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue Date: July 2007</td>
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<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
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<td>This standard replaces the PCAOB’s previous internal control standard, Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements. This principles-based auditing standard is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company’s financial statements, and, at the same time, eliminate procedures that are unnecessary. Auditing Standard No. 5 is required to be used by registered audit firms for all audits of internal control over financial reporting no later than for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted and encouraged.</td>
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<tr>
<td><strong>PCAOB Rule 3526, Communication with Audit Committees Concerning Independence (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”)</strong></td>
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<td>Issue Date: August 2008</td>
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<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
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<td>Rule 3526 requires the registered public accounting firm to</td>
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<td>• describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence;</td>
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<td>• discuss with the audit committee of the issuer the potential effects of any relationships that could impact independence, should they be appointed as the issuer’s auditor; and</td>
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<td>• document the substance of these discussions. These discussions should occur at least annually.</td>
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<td>The board also adjusted the implementation schedule for Rule 3523 as it applies to tax services. The board agreed not to apply Rule 3523 to tax services provided on or before December 31, 2008, when those services are provided during the audit period and are completed before the professional engagement period begins. The amendments to Rule 3523 became effective August 28, 2008. The remaining provisions of Rule 3526 became effective on September 30, 2008.</td>
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### Recent Auditing and Attestation Pronouncements and Related Guidance

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<tr>
<th>Rule</th>
<th>Description</th>
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<td><strong>PCAOB Rule 3525, Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting</strong> <em>(AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”)</em>&lt;br&gt;<strong>Issue Date: July 2007</strong>&lt;br&gt;(Applicable to audits conducted in accordance with PCAOB standards)</td>
<td>This rule requires a registered public accounting firm that seeks preapproval of an issuer audit client’s audit committee to perform internal control-related nonaudit services that are not otherwise prohibited by the act or the rules of the Securities and Exchange Commission (SEC) or the PCAOB to describe, in writing, to the audit committee the scope of the proposed service, discuss with the audit committee the potential effects of the proposed service on the firm’s independence, and document the substance of the firm’s discussion with the audit committee. These requirements parallel the auditor’s responsibility in seeking audit committee preapproval to perform tax services for an audit client under PCAOB Rule 3524, <em>Audit Committee Pre-approval of Certain Tax Services</em> <em>(AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”)</em>. This rule is effective for audits of fiscal years ending on or after November 15, 2007.</td>
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<td><strong>PCAOB Conforming Amendments to the Interim Auditing Standards</strong> <em>(AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)</em>&lt;br&gt;<strong>Issue Date: July 2007</strong>&lt;br&gt;(Applicable to audits conducted in accordance with PCAOB standards)</td>
<td>In conjunction with the PCAOB’s adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in appendix 3 of PCAOB Release No. 2007-005A at <a href="http://www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf">www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf</a>. These amendments are effective for audits of fiscal years ending on or after November 15, 2007, the same effective date of Auditing Standard No. 5.</td>
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<td><strong>PCAOB Release No. 2007-001, Observations on Auditors’ Implementation of PCAOB Standards Relating to Auditors’ Responsibilities With Respect to Fraud</strong> <em>(AICPA, PCAOB Standards and Related Rules, “Selected SEC-Approved PCAOB Releases”)</em>&lt;br&gt;<strong>Issue Date: January 2007</strong>&lt;br&gt;(Applicable to audits conducted in accordance with PCAOB standards)</td>
<td>This release focuses on aspects of the PCAOB’s interim auditing standards that address the auditor’s responsibility with respect to fraud, specifically AU section 316, <em>Consideration of Fraud in a Financial Statement Audit</em> <em>(AICPA, PCAOB Standards and Related Rules)</em>. This report does not change or propose to change any existing standard nor is the PCAOB providing any new interpretation of existing standards.</td>
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</table>
Recent Auditing and Attestation Pronouncements and Related Guidance

PCAOB Staff Questions and Answers, Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 100 par. .05)

Issue Date: April 2007
(Applicable to audits conducted in accordance with PCAOB standards)

Topics covered include the following:

- The application of PCAOB Rule 3522(a), Tax Transactions (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”), when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm
- Whether a public accounting firm can advise an audit client on the tax consequences of structuring a particular transaction
- Whether a registered public accounting firm’s independence is affected by the IRS’s subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in PCAOB Rule 3522(b)
- Clarification that the auditor must evaluate whether a person is in a financial reporting oversight role at affiliates and not just the audit client itself
- Clarification of the term other change in employment event as it relates to PCAOB Rule 3522(c)

PCAOB Staff Audit Practice Alert No. 2, Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 400 par. .02)

Issue Date: December 2007
(Applicable to audits conducted in accordance with PCAOB standards)

This practice alert highlights certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of generally accepted accounting principles that are particularly relevant to the current economic environment.

Accounting Issues and Developments

Convergence With International Financial Reporting Standards

.102 Since the signing of the Norwalk Agreement by FASB and the International Accounting Standards Board (IASB), the bodies have had a common goal—one set of accounting standards for international use. In this agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. In 2005 meetings FASB and the IASB reaffirmed their commitment to the convergence of U.S. GAAP and International Financial Reporting Standards (IFRS). A common set of high quality, globally accepted standards remains the long-term strategic priority of both FASB and the IASB.

.103 FASB and the IASB have undertaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and IFRS. These ongoing joint projects address the conceptual framework, business combinations, financial statement presentation, and revenue recognition. For more information on the status of this project go to www.fasb.org and www.iasb.org.

SEC Eases Acceptance of IFRS Financial Statements

.104 On December 21, 2007, the SEC took a major step towards easing the acceptance of IFRS financial statements by adopting rules to accept from foreign private issuers financial statements prepared in accordance with IFRS as issued by the IASB without reconciliation to U.S. GAAP. This rule marks an
important step in the process toward the development of a single set of high quality, globally accepted accounting standards. This rule became effective March 4, 2008. Readers can access this rule at www.sec.gov/rules/final/2007/33-8879.pdf.

.105 More than 100 countries now either require or allow the use of IFRS for the preparation of financial statements by listed companies, and additional countries are moving to do the same. This recent movement to IFRS outside the United States has resulted in an increase of filings with the SEC of foreign private issuers that represent in the footnotes to their financial statements that their financial statements comply with IFRS as published by the IASB—from a relative few in 2005 to approximately 110 in 2006. The SEC expects this number will continue to increase in the future, particularly pursuant to Canada’s announced move to IFRS, as there are currently approximately 500 foreign private issuers from Canada.

.106 This movement to IFRS also has begun to affect U.S. issuers, in particular those with a significant global footprint. For instance, certain U.S. issuers may compete for capital globally in industry sectors in which a critical mass of non-U.S. companies report under IFRS. Also, U.S. issuers with subsidiaries located in jurisdictions that have moved to IFRS may prepare those subsidiaries’ financial statements in IFRS for purposes of local regulatory or statutory filings. Readers should remain alert to developments regarding convergence.

IFRS “Roadmap”

.107 On August 27, 2008, the SEC voted to publish for public comment a proposed roadmap that could lead to the use of IFRS by U.S. issuers beginning in 2014. The SEC would make a decision in 2011 on whether adoption of IFRS is in the public interest and would benefit investors. The proposed multiyear plan sets out several milestones that, if achieved, could lead to the use of IFRS by U.S. issuers in their filings with the SEC.

.108 The top 20 companies in each industry, as determined by market capitalization, could elect to begin filing IFRS financial statements for fiscal periods ending after December 15, 2009. If, in 2011, the SEC adopts IFRS for all filers, the roadmap suggests mandatory filing for large accelerated filers beginning in 2014, accelerated filers in 2015, and nonaccelerated filers in 2016.

.109 The 60 day comment period will begin when the proposed roadmap is published in the federal register.

.110 Additionally, in the spotlight section of its Web site, the SEC provides information on the following topics and groups:

- SEC roundtable on IFRS held on August 4, 2008
- SEC roundtable on practical issues surrounding the use of IFRS in the United States in recent years, and the potential expanded use of IFRS in future years
- SEC roundtable on IFRS in the U.S. markets held on December 13, 2007
- Proposed rulemaking and request for public comments
- SEC staff roundtable on IFRS roadmap
- SEC press releases
- Staff review of financial statements prepared in accordance with IFRS
- Speeches and public statements

This information can be accessed at www.sec.gov/spotlight/ifrsroadmap.htm.
AICPA Launches IFRS.com Web Site

.111 The AICPA is calling for an orderly transition and reasonable time frame of three to five years for the U.S. accounting profession to adopt IFRS. During a FASB forum on June 16, 2008, held to facilitate an open dialogue about whether and how to move the U.S. financial reporting system to IFRS and define next steps in that process, it was noted that awareness of IFRS is growing, but most believe it will take three to five years to prepare.

.112 To assist in both awareness building and education, the AICPA launched a new Web site, www.ifrs.com, in May 2008. The site provides current information about developments in international convergence. The growing acceptance of IFRS as a basis for U.S. financial reporting represents a fundamental change for the U.S. accounting profession. Acceptance of a single set of high-quality accounting standards for worldwide use by public companies has been gaining momentum around the globe for the past few years.

.113 Developed by the AICPA, in partnership with its marketing and technology subsidiary, cpa2biz, IFRS.com provides a comprehensive set of resources for accounting professionals, auditors, financial managers, audit committees, and other users of financial statements.

.114 The Web site features tools and resources to help CPAs get acquainted with IFRS, the surrounding issues, and available support. Resources include a history of convergence, a high-level overview of the differences between IFRS and U.S. GAAP, frequently asked questions, articles, textbooks, continuing professional education (CPE) courses and live conference training, helpful links, and assistance for audit committee members.

FASB Accounting Standards Codification™

.115 On January 15, 2008, FASB launched the one-year verification period of FASB Accounting Standards Codification™ (ASC). FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing all authoritative literature in a topically organized structure. FASB ASC includes all accounting standards issued by a standard setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, AICPA, Emerging Issues Task Force (EITF), and related literature. FASB ASC also includes relevant authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance.

.116 The purpose of FASB ASC is not to change GAAP, but rather to reorganize thousands of GAAP pronouncements into approximately 90 topics. At the end of the one year verification period, FASB is expected to formally approve FASB ASC as the single source of authoritative U.S. accounting and reporting standards, other than guidance issued by the SEC. At that time, FASB will supersede all then-existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the codification will become nonauthoritative. FASB expects to approve FASB ASC in April 2009. FASB ASC can be accessed at http://asc.fasb.org/home.

.117 Constituents are encouraged to use FASB’s online FASB ASC Research System free of charge and provide feedback to FASB on the codification.

.118 The AICPA has published the Financial Reporting Alert FASB Codification Developments—2008 (product no. 029209kk). This Financial Reporting Alert is intended to provide a better understanding of FASB ASC, outline its structure, as well as provide case studies on navigating FASB ASC Research System and performing accounting research.

Summary of Recent Accounting Pronouncements and Related Guidance

.119 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. This alert is intended to be used in conjunction with AICPA Comprehensive Audit Risk Alert—2008 (product no. 022339kk); therefore, only industry specific pronouncements and related guidance or those of
specific significance to the industry are summarized herein. For information on accounting standards issued subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the CPA Letter and Journal of Accountancy.

### Recent Accounting Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Board/Statement</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>FASB Statement No. 162 (May 2008)</td>
<td>The Hierarchy of Generally Accepted Accounting Principles</td>
</tr>
<tr>
<td>FASB Statement No. 161 (March 2008)</td>
<td>Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133</td>
</tr>
<tr>
<td>FASB Statement No. 160 (December 2007)</td>
<td>Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51</td>
</tr>
<tr>
<td>FASB Statement No. 141 (revised 2007) (December 2007)</td>
<td>Business Combinations</td>
</tr>
<tr>
<td>FASB Statement No. 158 (September 2006)</td>
<td>Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)</td>
</tr>
<tr>
<td>FASB Statement No. 157 (September 2006)</td>
<td>Fair Value Measurements</td>
</tr>
<tr>
<td>FASB Interpretation No. (FIN) 48 (June 2006)</td>
<td>Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109</td>
</tr>
</tbody>
</table>

FASB Staff Position (FSP) FIN 48-2, Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises, issued in February 2008, defers the effective date of FIN 48 for certain nonpublic enterprises, as defined in the FSP, to the annual financial statements for fiscal years beginning after December 15, 2007.


FASB Staff Positions (FSPs) (Various dates) Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.
### Recent Accounting Pronouncements and Related Guidance

| AICPA Statement of Position (SOP) 07-1  
(AICPA, Technical Practice Aids, ACC sec. 10,930) | Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies  
In February 2008, FASB issued FSP SOP 07-1-1, Effective Date of AICPA Statement of Position 07-1, which indefinitely defers the effective date of SOP 07-1. Entities that early adopted SOP 07-1 before December 15, 2007 are permitted, but not required, to continue to apply the provisions of the SOP. No other entities may adopt the provision of the SOP, subject to the exception in the following sentence: “If a parent entity that early adopted the SOP chooses not to rescind its early adoption, an entity consolidated by that parent entity that is formed or acquired after that parent entity’s adoption of the SOP must apply the provisions of the SOP in its standalone financial statements.” |
|---|---|
| Technical Questions and Answers (TIS) section 1100.15 (AICPA, Technical Practice Aids)  
(Nonauthoritative) | This question and answer discusses auditing and accounting issues related to withdrawal restrictions placed on short-term investments by a money market fund or its trustee. |
| TIS sections 6910.25–.28 (AICPA, Technical Practice Aids)  
(Nonauthoritative) | These questions and answers discuss financial statement presentation considerations for investment companies. |
| TIS sections 6140.20–.22 (AICPA, Technical Practice Aids)  
(Nonauthoritative) | These questions and answers discuss not-for-profit organizations fund-raising expenses. |
| TIS sections 6931.08–.10 (AICPA, Technical Practice Aids)  
(Nonauthoritative) | These questions and answers discuss various employee benefit plan topics. |
| AICPA Practice Guide  
(Nonauthoritative) | Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48 |

.120 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance to the real estate and construction industries are briefly explained here. The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. The AICPA Comprehensive Audit Risk Alert—2008 and other AICPA industry specific alerts also contain summaries of recent pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or visit www.cpa2biz.com.
Real Estate Accounting Issues and Developments

Fair Value Measurements

FASB Statement No. 157

.121 In September 2006, FASB issued FASB Statement No. 157 to provide enhanced guidance for using fair value to measure assets and liabilities. This standard defines fair value and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances.

.122 Prior to this statement, there were different definitions of fair value, and guidance for applying those definitions was dispersed among many accounting pronouncements. Difference in the existing guidance created inconsistencies that added to the complexity in applying GAAP. FASB Statement No. 157 provides increased consistency and comparability in fair value measurements. Expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the use of fair value in the financial statements, the inputs used to develop the measurements, and the effect of the measurements on earnings (or changes in net assets) for the period.

.123 In February 2008, FASB issued FASB Staff Position (FSP) FAS 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13, which amends FASB Statement No. 157, to exclude FASB Statement No. 13, Accounting for Leases, and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under FASB Statement No. 13. However, this scope exception does not apply to assets acquired and liabilities assumed in a business combination that are required to be measured at fair value under FASB Statement No. 141, Business Combinations or FASB Statement No. 141(R), Business Combinations, regardless of whether those assets and liabilities are related to leases. This FSP is effective upon the initial adoption of FASB Statement No. 157.

.124 FASB Statement No. 157 is effective for financial statements issued after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. However, in February 2008, FASB also issued FSP FAS 157-2, Effective Date of FASB Statement No. 157, which is effective upon issuance. This FSP delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow FASB and its constituents the time to consider the various implementation issues associated with FASB Statement No. 157. In October 2008, FASB issued FSP FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active, which clarifies FASB Statement No. 157’s application in an inactive market and also amends the standard to include an illustrative example. See the section of this alert entitled Measurements of Fair Value in Illiquid Markets for further discussion of FSP FAS 157-3. Readers can access the full text of FASB Statement No. 157 and the previously referenced FSPs on the FASB Web site at www.fasb.org.

Measurements of Fair Value in Illiquid Markets

.125 Most of the subprime mortgages making headlines were ultimately financed via securitization issuances. As a result of the growing numbers of defaults and foreclosures and uncertainty about the future, investors in these securities and lenders who issued these securities have almost come to a standstill causing a liquidity crisis. This has caused significant declines in the values of existing loans and mortgage backed securities held by both lenders and investors given the lack of demand. This has also spread to a lack of demand for investments in CDOs, as many hold securities backed by subprime mortgages, and even the short-term commercial paper market.
Given the state of the market, there is confusion around the use of “market” quotes and whether current market prices represent fair value in accordance with FASB Statement No. 157 or are in actuality distressed sales. To clarify the application of FASB Statement No. 157 in an inactive market, in October 2008 FASB issued FSP FAS 157-3. This FSP also amends FASB Statement No. 157 to include an illustrative example. FSP FAS 157-3 noted the consistency between the guidance provided in it and the guidance provided in the SEC and FASB press release. Readers are encouraged to review the full text of the FSP and the amended standard (inclusive of its recently added illustrative example) on the FASB Web site at www.fasb.org. The FSP was effective upon issuance, including any prior periods for which financial statements have not been issued. Any revisions from changes in valuation techniques or their application shall be accounted for as a change in accounting estimate in accordance with FASB Statement No. 154, Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3; however, the disclosure provisions of FASB Statement No. 154 for such revisions are not required.

FSP FAS 157-3 noted, “Broker (or pricing service) quotes may be an appropriate input when measuring fair value, but they are not necessarily determinative if an active market does not exist for the financial asset… In weighing a broker quote as an input to a fair value measurement, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence.” As discussed in paragraph 7 of FASB Statement No. 157, “[A]n orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).” Low transaction volume involving such assets does not necessarily translate into forced sales, nor does it necessarily mean the market is inactive. To deem a transaction forced or disorderly, persuasive evidence and judgment are required.

If transaction volume is too low to provide accurate pricing information and therefore a level 1 input, those observable transactions are to be considered level 2 inputs or even level 3 inputs if they are significantly adjusted. The AICPA Center for Audit Quality’s (CAQ) October 2007 white paper on the topic noted some characteristics of an inactive market are “few transactions for the asset, the prices are not current, price quotations vary substantially, or in which little information is released publicly.” In describing an inactive market as well, the SEC and FASB Press Release noted, “A significant increase in the spread between the amount sellers are ‘asking’ and the price that buyers are ‘bidding’, or the presence of a relatively small number of ‘bidding’ parties, are indicators that should be considered in determining whether a market is inactive.”

The lack of an active market and the information obtained from it require further analysis. According to FSP FAS 157-3, “[I]n cases where the volume and level of trading activity in the asset have declined significantly, the available prices vary significantly over time or among market participants, or the prices are not current, the observable inputs might not be relevant and could require significant adjustment.” Further, the SEC and FASB Press Release noted, “[I]n some cases using unobservable inputs (level 3) might be more appropriate than using observable inputs (level 2); for example, when significant adjustments are required to observable inputs it may be appropriate to utilize an estimate based primarily on unobservable inputs.” When significant adjustments are made to an observable input (level 2), it becomes a level 3 fair value measurement.

Paragraph C85 of FASB Statement No. 157 states, “[T]he reporting entity may use its own data to develop unobservable inputs, provided that there is no information reasonably available without undue cost and effort that indicates that market participants would use different assumptions in pricing the asset or liability.” A reporting entity is prohibited from ignoring observable transaction or assumptions that are reasonably available without undue cost and effort.

The FSP concluded, “[T]he use of a reporting entity’s own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available.” Similarly, the SEC and FASB press release noted, “[i]n some cases, multiple inputs from different sources
may collectively provide the best evidence of fair value. In these cases expected cash flows would be considered alongside other relevant information. The weighting of the inputs in the fair value estimate will depend on the extent to which they provide information about the value of an asset or liability and are relevant in developing a reasonable estimate.”

.132 The AICPA, in October 2008 (as mentioned in the “Audit Risks Arising From Current Economic Conditions” section), issued a nonauthoritative TPA around liquidity restrictions. TIS section 1100.15 provides useful information to accountants and auditors when an entity’s short-term investments (such as money market funds) have become restricted by the fund (or its trustee). The full technical practice aid can be obtained from the AICPA’s Web site, www.aicpa.org.

FASB Statement No. 159

.133 Subsequent to the issuance of FASB Statement No. 157, FASB issued FASB Statement No. 159. This statement is expected to expand the use of fair value measurement, which is consistent with FASB’s long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159 allows entities to choose to measure many financial instruments and certain other items at fair value. The standard permits an entity to elect the fair value option on an instrument-by-instrument basis; and once the election is made, it is irrevocable. This statement’s objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently, without having to apply complex hedge accounting provisions.

.134 In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments, and FASB Statement No. 157.

.135 FASB Statement No. 159 is effective as of the beginning of an entity’s first fiscal year after November 15, 2007. FASB and the SEC expressed concern in the way some early adopters applied the transition provisions of the standard. The CAQ issued an alert on this development in April 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles based standard, such as this, is applied in a good faith manner consistent with those objectives and principles. Specifically the alert warns auditors to “be alert for circumstances in which an entity proposes to adopt FASB Statement No. 159 in a manner that is contrary to the principles and objectives outlined in the standard.” The alert can be accessed at www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf. Readers can access the full text of FASB Statement No. 159 on the FASB Web site at www.fasb.org.

Loan Modifications Within the Scope of Qualifying Special Purpose Entities

.136 When the accounting world began to digest the state of the residential real estate market, a common question surfaced around what activities were permitted by a servicer when loans had been securitized by a qualifying special purpose entity (QSPE) in accordance with FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, and therefore had not been consolidated by the transferor entity. After a series of SEC letters in 2007, the chief accountant of the SEC issued a letter dated January 8, 2008, that finalized the SEC’s position on this matter. The letter can be accessed at sec.gov/info/accountants/staffletters/hanish010808.pdf. The letter describes the issue as follows: “[N]either FAS 140 nor the related interpretative guidance indicates whether it would be appropriate for a servicer to modify a securitized mortgage in a QSPE prior to an actual delinquency or default and, if so, the relevant disclosures that may be necessary when such modifications occur.” For an entity to maintain QSPE status, its activities are restricted by FASB Statement No. 140.

.137 Stating the SEC’s position on the matter, this letter referred to the Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans (ASF Framework) issued by the American Securitization Forum on December 6, 2007, as revised on July 8, 2008, which can be found at
Essentially, the ASF Framework provides guidance to servicers around refinancing and categorizes select subprime residential adjustable rate mortgage loans into three segments. Segment two contains mortgages where default is deemed to be reasonably foreseeable, and these loans have therefore been permitted to be modified before default occurs without invalidating an entity’s QSPE status. It was determined no additional interpretative guidance from FASB was necessary. However, it should be noted this is interim guidance as FASB has been in the process of simplifying the guidance in FASB Statement No. 140 since 2003.

FASB Statement No. 140 Project

.138 The board has undertaken a project to amend and simplify FASB Statement No. 140. The board has issued a proposed exposure draft in the third quarter of 2008 and expects to issue a final document in the fourth quarter of 2008. This project is being performed in conjunction with FASB’s project on FASB Interpretation No. (FIN) 46, Consolidation of Variable Interest Entities. The proposed amendments to FASB Statement No. 140 should be applied in fiscal years beginning after November 15, 2009 (effective date), on a prospective basis. QSPEs that existed prior to the effective date must also apply these amendments. FASB is considering a different effective date for private entities. The proposed amendments include the following:

- Removing the concept of a qualifying special purpose entity from FASB Statement No. 140 and removing the scope exception for QSPEs from FIN 46 (revised 2003), Consolidation of Variable Interest Entities
- Changing the derecognition criteria
- Changing the initial and subsequent measurement of beneficial interests received by the transferor
- Removing the fair value practicability exception
- Changing the exceptions related to guaranteed mortgage securitizations
- Changing the disclosure requirements

.139 FASB has also decided to separately issue a FSP that would require many of the approved disclosures to be made by an entity as soon as possible, that is, before the effective date of the amendments discussed previously. A draft of the proposed FSP, FSP FAS 140-e and FIN 46(R), Disclosures About Transfers of Financial Assets and Interests in Variable Interest Entities, was issued on September 15, 2008, for a 30 day comment period, and a final FSP is expected to be issued in the fourth quarter of 2008. In the proposed FSP, FASB recommends the FSP be effective at the end of the reporting period in which the FSP is issued due to the urgent need to improve transparency. Accountants and auditors are encouraged to follow the status of this proposed FSP on the FASB Web site. Readers should also note the exposure draft of the proposed amendments to FIN 46 (revised December 2003), posted on the FASB Web site in September 2008.

FASB Staff Position FAS 140-3

.140 In February 2008, FASB issued FSP FAS 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions, to provide guidance when a purchase of a financial asset and its financing via repurchase agreement occurs contemporaneously. It is effective for financial statements issued for fiscal years beginning after November 15, 2008, and interim periods within those years. No early adoption is permitted, and it shall be applied prospectively to initial transfers and repurchase financings that are executed on or after the beginning of the fiscal year in which this FSP is initially applied.

.141 Determining whether the transaction is linked is the first step. To avoid being linked, all of the following criteria must be met:

- The two transactions have a valid and distinct business or economic purpose for being entered into separately.
- The initial transferor does not regain control over the financial asset from the repurchase financing.
- The initial transfer and the repurchase financing are not contractually contingent.
The repurchase financing gives the initial transferor recourse to the initial transferee upon default.

The financial asset is readily obtainable in the marketplace.

The maturity date of the repurchase financing must be prior to the maturity of the financial asset.

.142 If the transaction is deemed linked, it must be evaluated for sale accounting under FASB Statement No. 140. If it does not qualify as a sale, the transaction shall be accounted for based on the overall economics, which typically creates a forward contract to be evaluated for derivative treatment under FASB Statement No. 133, Accounting for Derivatives and Hedging Activities.

Buy-Sell Clauses

.143 In December 2007, FASB ratified the consensus on EITF Issue No. 07-6, “Accounting for the Sale of Real Estate Subject to the Requirements of FASB Statement No. 66 When the Agreement Includes a Buy-Sell Clause.” It will be effective for new arrangements entered into and any assessments performed in fiscal years beginning after December 15, 2007, and any interim periods within those years.

.144 The buy-sell clause is a contractual term that gives both of the investors of the jointly owned entity the ability to offer to buy the other investor’s interest. It is designed to incorporate into the transaction price the natural tension between the interests of both investors in a buy-sell situation and thereby achieve an acceptable outcome for both investors. Furthermore, the buy-sell clause provides investors with an exit strategy for closely held investments. The issue is whether an irrevocable buy-sell clause represents a prohibited form of continuing involvement that would preclude partial sale and profit recognition pursuant to FASB Statement No. 66, Accounting for Sales of Real Estate, assuming all other criteria have been met. EITF Issue No. 07-6 states the aforementioned determination is a matter of judgment and requires consideration of all relevant facts and circumstances of the transaction at the time the real estate is sold into the jointly owned entity. This clause should be evaluated to determine if it gives the buyer an in-substance option to acquire the buyer’s interest in the jointly owned entity (thereby reacquiring the real estate).

Accounting by Lessees for Maintenance Deposits

.145 At the EITF meeting on June 25, 2008, EITF Issue No. 08-3, “Accounting by Lessees for Maintenance Deposits,” was ratified with an effective date for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Earlier application is not permitted. The issue addressed in EITF Issue No. 08-3 is whether lessees of equipment should account for maintenance deposits to the lessor as deposits or as contingent rental expense. These deposits are reimbursed to the lessee for maintenance costs over the term of the lease, but any unused amounts remaining at the end of the lease are nonrefundable. Only deposits with the aforementioned characteristics are within the scope of this issue.

.146 When the equipment lease provides for required maintenance deposits to the lessor, the initial accounting is as a deposit. When the maintenance is performed and reimbursed by the lessor to the lessee, the deposit can either be expensed or capitalized in accordance with the lessee’s maintenance accounting policy. Once it is probable that any remaining deposited amounts will not be used for maintenance activities for the leased equipment, the amount is recognized as an additional expense immediately by the lessee. This issue does not provide revenue recognition guidance for the lessor. Readers can access the complete EITF abstract on the FASB Web site for further details.

Construction Accounting Issues and Developments

Revenue Recognition

.147 As noted previously in this alert, SOP 81-1 provides guidance on revenue recognition for construction contractors. SOP 81-1 requires a contractor to use the percentage-of-completion method for recognizing revenue whenever it can produce reasonably dependable estimates. A rebuttable presumption exists that the percentage-of-completion method will produce reasonably dependable estimates.
The completed-contract method should be used only in instances in which reasonable, dependable estimates of construction costs cannot be made. The completed-contract method may also be used if there are no material differences between that method and the percentage-of-completion method. Situations in which there are no material differences may occur when a contractor performs primarily short-term contracts, for example, a small plumbing contractor whose projects are completed so quickly that the work is somewhat analogous to the manufacture of shelf production items for sale.

The revenue recognition method should be disclosed in the financial statements. If the percentage-of-completion method is used, the financial statements should disclose the method of computing percentage-of-completion (for example, cost-to-cost). If the completed contract method is used, the reason for selecting the method should be indicated.

In December 1999, the SEC, in an attempt to fill the gap in general revenue recognition guidance, released Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*. SAB No. 101 was superseded by SAB No. 104, *Revenue Recognition*, in December 2003. Financial statement preparers and auditors of public construction companies are most directly affected by SAB No. 104. However, auditors of nonpublic companies may also find the information contained in SAB No. 104 useful. The issuance of SAB No. 104 did not affect the guidance for revenue recognition contained in SOP 81-1.

**Recent AICPA Independence and Ethics Pronouncements**

AICPA *Independence and Ethics Developments—2008* (product no. 022479kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

**On the Horizon**

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to the real estate and construction industries or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

The following table lists the various standard setting bodies’ Web sites, where information may be obtained on outstanding exposure drafts, including exposure drafts that may be downloaded. These Web sites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.

<table>
<thead>
<tr>
<th>Standard-Setting Body</th>
<th>Web Site</th>
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<tr>
<td>AICPA Auditing Standards Board (ASB)</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/</a></td>
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<tr>
<td>Financial Accounting Standards Board (FASB)</td>
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</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
<td><a href="http://www.pcaob.org">www.pcaob.org</a></td>
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(continued)
Auditing Pipeline—Nonissuers

ASB Clarity Project

.154 The Auditing Standards Board (ASB) formed a Clarity Task Force to address concerns over the clarity, length, and complexity of GAAS. In March 2007, the ASB approved for exposure a discussion paper Improving the Clarity of ASB Standards. Over the next two or three years, the ASB will be redrafting all of the existing auditing sections contained in the Codification of Statements on Auditing Standards (AU sections of the AICPA’s Professional Standards), to apply the clarity drafting conventions and to converge with the International Standards on Auditing issued by the International Auditing and Assurance Standards Board. The ASB proposes that, except to address current issues, all redrafted standards will become effective at the same time. Only those standards needing to address current issues would have earlier effective dates. The ASB believes that a single effective date will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. Currently, the date is expected to be for audits of financial statements for periods beginning no earlier than December 15, 2010. This date depends on satisfactory progress being made, and will be amended should that prove necessary. See the Clarity Project Explanatory Memorandum and the discussion paper Improving the Clarity of ASB Standards at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm.

Auditing Pipeline—Issuers

.155 Guidance issued by the PCAOB is included in the section of this alert titled “Summary of Recent Auditing and Attestation Pronouncements and Related Guidance.” For more information regarding recent developments at both the SEC and PCAOB, readers may refer to the Audit Risk Alert SEC and PCAOB Developments—2008.

Accounting Pipeline

.156 A number of accounting projects and pronouncements are currently in progress. For a summary of significant accounting projects and pronouncements, refer to AICPA Comprehensive Audit Risk Alert—2008 (product no. 022339kk). Such in progress issues include the following:

- Accounting for hedging activities exposure draft
- Accounting for contingencies exposure draft
- Phase 2 of the fair value project
- Transfers of financial assets project
- Earnings per share convergence project
- Income tax convergence project
- Leases project
- Reporting discontinued operations project
- Going concern proposed statement
Subsequent events proposed statement
Amendments to FIN 46(R) proposed statement

Fair Value

.157 During phase 1 of FASB’s fair value option project, FASB issued FASB Statement No. 159, which was previously discussed. In phase 2 of the project, FASB will consider allowing the fair value option for certain nonfinancial assets and nonfinancial liabilities and deposit liabilities of depository institutions, which are excluded from the scope of FASB Statement No. 159. Deliberations on phase 2 are expected to begin in the first quarter of 2008. Readers should remain alert to developments by visiting the FASB Web site.

Proposed FASB Emerging Issues Task Force Issues and Staff Positions

.158 Proposed FASB EITF Issues. Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

.159 Proposed FASB Staff Positions (FSPs). A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

Resource Central

.160 The following are various resources that practitioners engaged in the real estate or construction industries may find beneficial.

Publications

.161 Practitioners may find the following publications useful. Choose the format best for you—online, print, or CD-ROM.

- Audit and Accounting Guide Construction Contractors (2008) (product no. 012588kk [paperback], WCC-XXkk [online with the associated Audit Risk Alert], or DCC-XXkk [CD-ROM with the associated Audit Risk Alert])
- Audit and Accounting Guide Investment Companies (2008) (product no. 012628kk [paperback], WIN-XXkk [online with the associated Audit Risk Alert], or DIN-XXkk [CD-ROM with the associated Audit Risk Alert])
- Audit and Accounting Guide Depository and Lending Institutions (2008) (product no. 012738kk [paperback], WDL-XXkk [online with the associated Audit Risk Alert], or DDL-xxkk [CD-ROM with the associated Audit Risk Alert])
- Audit Guide Analytical Procedures (2008) (product no. 012558kk [paperback], WAN-XXkk [online], or DAN-XXkk [CD-ROM])
- Audit Guide Assessing and Responding to Audit Risk in a Financial Statement Audit (2006) (product no. 012456kk [paperback] or WRA-XXkk [online])
- Audit Guide Auditing Derivative Instruments, Hedging Activities, and Investments in Securities (2008) (product no. 012528kk [paperback], WDI-XXkk [online], or DDI-XXkk [CD-ROM])
- Audit Guide Auditing Revenue in Certain Industries (2008) (product no. 012518kk [paperback], WAR-XXkk [online], or DAR-XXkk [CD-ROM])
- Audit Guide Audit Sampling (2008) (product no. 012538kk [paperback], WAS-XXkk [online], or DAS-XXkk [CD-ROM])
- Audit Guide Service Organizations: Applying SAS No. 70, as Amended (2008) (product no. 012778kk [paperback], WSV-XXkk [online], or DSV-XXkk [CD-ROM])
• AICPA Comprehensive Audit Risk Alert—2008 (product no. 022339kk [paperback], WGE-XXkk [online], or DGE-XXkk [CD-ROM])
• Audit Risk Alert Compilation and Review Developments—2008 (product no. 022309kk [paperback], WCR-XXkk [online], or DCR-XXkk [CD-ROM])
• Audit Risk Alert Depository and Lending Institution Industry Developments—2008 (product no. 022299kk [paperback], WDL-XXkk [online with the associated Audit and Accounting Guide], or DDL-XXkk [CD-ROM with the associated Audit and Accounting Guide])
• Audit Risk Alert Independence and Ethics Developments—2008 (product no. 022479kk [paperback], WIA-XXkk [online], or DIA-XXkk [CD-ROM])
• Audit Risk Alert Investment Companies Industry Developments—2008 (product no. 022369kk [paperback], WIN-XXkk [online with the associated Audit and Accounting Guide], or DIN-XXkk [CD-ROM with the associated Audit and Accounting Guide])
• Audit Risk Alert SEC and PCAOB Developments—2008 (product no. 022499kk [paperback])
• Audit Risk Alert Understanding the New Auditing Standards Related to Risk Assessment (product no. 022526kk [paperback])
• Checklist Supplement and Illustrative Financial Statements for Construction Contractors (product no. 008928kk [paperback] or WCS-CLkk [online])
• Checklists and Illustrative Financial Statements for Depository and Lending Institutions (product no. 008918kk [paperback] or WDP-CLkk [online])
• Checklist Supplement and Illustrative Financial Statements for Investment Companies (product no. 008948kk [paperback] or WIS-CLkk [online])
• Checklist Supplement and Illustrative Financial Statements for Real Estate Ventures (product no. 008978kk [paperback] or WRS-CLkk [online])
• Audit and Accounting Manual (2008) (product no. 005138kk [paperback], WAM-XXkk [online], or AAM-XXkk [loose leaf])
• Accounting Trends & Techniques, 62nd Edition (product no. 009900kk [paperback] or WAT-XXkk [online])

Additional resources for accountants in business and industry are the Financial Reporting Alert series, designed to be used by members of an entity’s financial management and audit committee to identify and understand current accounting and regulatory developments affecting the entity’s financial reporting.

• Financial Reporting Alert Current Accounting Issues and Risks—2008 (product no. 029208kk)
• Financial Reporting Alert FASB Codification Developments—2008 (product no. 029209kk)

AICPA reSOURCE: Accounting and Auditing Literature

The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm’s needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to the AICPA’s latest Professional Standards, Technical Practice Aids, Audit and Accounting Guides (more than 20), Audit Risk Alerts (more than 15), and Accounting Trends & Techniques. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Continuing Professional Education

The AICPA offers a number of CPE courses that are valuable to CPAs working in public practice and industry, including the following:
• AICPA’s Annual Accounting and Auditing Update Workshop (2008–2009 Edition) (product no. 736184kk [text] or 187192kk [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.

• SEC Reporting (product no. 736775kk [text] or 186756kk [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements and gives you examples and tips for ensuring compliance.

• International Versus U.S. Accounting: What in the World is the Difference? (product no. 731666kk [text]). With the fast pace of the convergence project, understanding the differences between IFRS and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRS and U.S. GAAP.

• The International Financial Reporting Standards: An Overview (product no. 157220kk [online] or 739750HSkk [DVD]). This course captures a live presentation on IFRS given to the AICPA board of directors.

.165 Among the many courses, the following are specifically related to the real estate or construction industries:

• Real Estate Accounting and Auditing (product no. 730608kk)

• FIN 46R Variable Interest Entity Consolidation Rules: Not Just a Big Company Issue! (product no. 733212kk)

• Construction Contractors: Accounting, Auditing, and Tax (product no. 736432kk)

• Construction Contractors Advanced Issues (product no. 731994kk)

Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.166 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz, is AICPA’s flagship online learning product. AICPA members pay $180 for a new subscription and $149 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to the real estate industry include the following:

• Planning the Audit of a Real Estate Entity’s Financial Statements

• Accounting for Sale-Leasebacks and Nonmonetary Exchanges

• Accounting for the Sale of Real Estate Assets

• Accounting for Rental Operations and Investments in Real Estate Ventures

• Accounting for the Impairment of Completed Real Estate Projects

• Auditing Real Estate Transactions

• Introduction to the Real Estate Valuation Process

.167 Some topics of special interest to the construction industry include the following:

• Construction Contractors: Nature and Significance of the Construction Industry and Cost Allocations

• Construction Contractors: Nature of the Construction Industry

• Construction Contractors: Contract Accounting

• Construction Contractors: Other Auditing Considerations
Construction Contractors: Audit Risks in the Construction Industry

Construction Contractors: Internal Control Issues in the Construction Industry

To register or learn more, visit www.cpa2biz.com.

Webcasts

Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two hour CPE programs that bring you the latest topics from the profession’s leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter via webcast, covers a broad array of “hot topics” that successful organizations employ and subjects that are important to the CFO’s personal success. From financial reporting, budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession’s leading experts on what is “hot” at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you “plugged in” to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA’s Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. Beginning January 14, 2008, hotline hours were extended so that the hotline is now available from 9 a.m. to 8 p.m. on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/.

Ethics Hotline

In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA’s Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077.
Industry Conferences

.174 The AICPA offers an annual National Real Estate Conference in the fall. The National Real Estate Conference is a two day conference designed to update attendees on recent developments related to real estate accounting and auditing, tax, and management issues. It delivers solid news about the emerging trends in the real estate market and offers new ideas for the accounting and financial management of the real estate industry.

.175 The AICPA also offers an annual National Construction Industry Conference in the late fall. The National Construction Industry Conference is a two-day conference on the latest industry trends, as well as most recent compliance issues.

.176 For further information about these conferences, call (888) 777-7077 or visit www.cpa2biz.com.

The Center for Audit Quality

.177 The CAQ, which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ’s mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession’s core values of integrity, objectivity, honesty, and trust.

.178 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit thecaq.aicpa.org.

Industry Web Sites

.179 The Internet covers a vast amount of information that may be valuable to auditors of real estate entities, including current industry trends and developments.

.180 Some of the more relevant sites for auditors with real estate clients include those shown in the following table:

<table>
<thead>
<tr>
<th>Organization</th>
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<tr>
<td>American Securitization Forum</td>
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<tr>
<td>CB Richard Ellis</td>
<td><a href="http://www.cbre.com/">www.cbre.com/</a></td>
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<td>Colliers International</td>
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<td>Grubb &amp; Ellis Company</td>
<td><a href="http://www.grubb-ellis.com/">www.grubb-ellis.com/</a></td>
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<td>Lodging Econometrics</td>
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<tr>
<td>Mortgage Bankers Association</td>
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<td>National Association of Realtors</td>
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<tr>
<td>National Association of Real Estate Investment Trusts</td>
<td><a href="http://www.reit.com/">www.reit.com/</a></td>
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<td>RealtyTrac</td>
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<tr>
<td>The Real Estate Roundtable</td>
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<td>Torto Wheaton Research</td>
<td><a href="http://www.twr.com/">www.twr.com/</a></td>
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<tr>
<td>Urban Land Institute</td>
<td><a href="http://www.uli.org">www.uli.org</a></td>
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</tbody>
</table>

The real estate and construction practices of some of the larger CPA firms may also contain industry-specific auditing and accounting information that is helpful to auditors.

This Audit Risk Alert replaces *Real Estate Industry Developments—2007/08* and *Construction Contractors Industry Developments—2007/08*.

The Audit Risk Alert *Real Estate and Construction Industry Developments* will be published annually. As you encounter audit or industry issues that you believe warrant discussion in next year’s Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to klichtenstein@aicpa.org or write to:

Keira A. Lichtenstein, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110
Appendix—Additional Web Resources

.185 Here are some useful Web sites that may provide valuable information to accountants.

<table>
<thead>
<tr>
<th>Web Site Name</th>
<th>Content</th>
<th>Web Site</th>
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<tbody>
<tr>
<td>American Institute of CPAs (AICPA)</td>
<td>Summaries of recent auditing and other professional standards as well as other AICPA activities</td>
<td><a href="http://www.aicpa.org">www.aicpa.org</a>, <a href="http://www.cpa2biz.com">www.cpa2biz.com</a>, <a href="http://www.ifrs.com">www.ifrs.com</a></td>
</tr>
<tr>
<td>AICPA Accounting Standards Executive Committee (AcSEC)</td>
<td>Issues guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards</a></td>
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<tr>
<td>AICPA Accounting and Review Services Committee (ARSC)</td>
<td>Develops and issues review and compilation standards and interpretations</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee</a></td>
</tr>
<tr>
<td>AICPA Professional Issues Task Force (PITF)</td>
<td>Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force</a></td>
</tr>
<tr>
<td>Economy.com</td>
<td>Source for analyses, data, forecasts, and information on the United States and world economies</td>
<td><a href="http://www.economy.com">www.economy.com</a></td>
</tr>
<tr>
<td>The Federal Reserve Board</td>
<td>Key interest rates</td>
<td><a href="http://www.federalreserve.gov">www.federalreserve.gov</a></td>
</tr>
<tr>
<td>Financial Accounting Standards Board (FASB)</td>
<td>Summaries of recent accounting pronouncements and other FASB activities</td>
<td><a href="http://www.fasb.org">www.fasb.org</a></td>
</tr>
<tr>
<td>USA.gov</td>
<td>Portal through which all government agencies can be accessed</td>
<td><a href="http://www.usa.gov">www.usa.gov</a></td>
</tr>
<tr>
<td>Government Accountability Office (GAO)</td>
<td>Policy and guidance materials and reports on federal agency major rules</td>
<td>ww.gao.gov</td>
</tr>
<tr>
<td>Governmental Accounting Standards Board (GASB)</td>
<td>Summaries of recent accounting pronouncements and other GASB activities</td>
<td><a href="http://www.gasb.org">www.gasb.org</a></td>
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<td>International Accounting Standards Board (IASB)</td>
<td>Summaries of International Financial Reporting Standards and International Accounting Standards</td>
<td><a href="http://www.iasb.org">www.iasb.org</a></td>
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<td>International Auditing and Assurance Standards Board (IAASB)</td>
<td>Summaries of International Standards on Auditing</td>
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</tr>
<tr>
<td>International Federation of Accountants (IFAC)</td>
<td>Information on standards setting activities in the international arena</td>
<td><a href="http://www.ifac.org">www.ifac.org</a></td>
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<td>Private Company Financial Reporting Committee (PCFRC)</td>
<td>Information on the initiative to further improve FASB’s standard setting process to consider needs of private companies and their constituents of financial reporting.</td>
<td><a href="http://www.pcfr.org">www.pcfr.org</a></td>
</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
<td>Information on accounting and auditing activities of the PCAOB and other matters</td>
<td><a href="http://www.pcaob.org">www.pcaob.org</a></td>
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[The next page is 8311.]
AAM Section 8100

Investment Companies Industry Developments—2008

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of investment companies with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an other auditing publication as defined in AU section 150, Generally Accepted Auditing Standards (AICPA, Professional Standards, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate.

The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Kenneth R. Biser, CPA, MBA
Technical Manager
Accounting and Auditing Publications

Acknowledgments

The AICPA staff is grateful to the following individuals for their essential contributions in creating this publication.

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Gregory Levy, CPA
Aaron Masek, CPA
Irina Portnoy, CPA
Maryna Tully, CPA

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your investment companies audits. This alert also can be used by an entity’s internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool in helping you identify the significant risks that may result in the material misstatement of financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.
This alert is intended to be used in conjunction with the Comprehensive Audit Risk Alert—2008 (product no. 022339kk), which can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

**Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement**

An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor’s understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity’s financial performance
- Internal control, which includes the selection and application of accounting policies

The investment companies industry may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

The auditor should obtain an understanding of the entity’s objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity’s ability to achieve its objectives and execute its strategies or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity’s business also is dynamic, and the entity’s strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client’s environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

**Economic and Industry Developments**

**The State of the Economy**

When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on the entity’s financial statements being audited.
Unprecedented Events in the Financial Markets

.09 During 2008, unprecedented events occurred in the financial markets, including the failure of a major investment bank, acquisitions of several investment and commercial banks (including some that required assistance from federal agencies), and the placement into conservatorship of Fannie Mae and Freddie Mac. Further, several foreign financial institutions received assistance from their national governments or entered into similar acquisition agreements. Additionally, on September 17, 2008, a significant publicly registered money market fund declined below the industry standard of $1.00 per share on a market value basis due to a combination of holdings of short term securities issued by the failed investment bank and major shareholder redemptions. As a result of these events, the condition of the fixed income markets worsened. Corporations and financial institutions generally recognized as creditworthy began experiencing difficulty borrowing money in the financial markets for any period of time longer than an overnight basis.

.10 In response, the U.S. Senate and, on October 3, 2008, the U.S. House of Representatives passed a bill that, among other things, appropriated up to $700 billion to purchase various forms of asset-backed securities and made a number of changes to the Internal Revenue Code (IRC). The repercussions of these events are just beginning to be felt in the wider economy. What impact they will have in 2009 is impossible to predict.

New Audit Risk Alert to Address Current Market Conditions

.11 This industry alert discusses the current economic environment (including basic measures of economic activity) and the economy’s effect on the investment companies industry. In light of the economic situation, the AICPA has developed a dedicated Audit Risk Alert, Current Economic Crisis: Accounting and Auditing Considerations—2009 (product no. 0223308kk), to address common accounting and auditing concerns relative to current market conditions that are affecting all industries. The alert also discusses a number of resources to assist in fair value accounting and its associated audit risks. Please visit www.cpa2biz.com for upcoming AICPA products, including the alert mentioned here, to help navigate this trying time.

Basic Measures of Economic Activity—Gross Domestic Product, Unemployment, and Interest Rates

.12 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.2 percent in 2007. According to 2008 third quarter final estimates, real GDP decreased at an annual rate of 0.5 percent, which is down significantly from the 2.8 percent increase in real GDP during the second quarter of 2008.

.13 The unemployment rate remained relatively unchanged during 2007, holding between 4.4 percent and 5.0 percent, with an annual average rate of 4.6 percent. However, during 2008, the unemployment rate rose dramatically. As of December 2008, the unemployment rate reached its highest level in 2008 at 7.2 percent, representing approximately 11.1 million people.

.14 The target for the federal funds rate remained stable at 5.25 percent from June 2006 to September 2007 when the Federal Reserve began decreasing rates. Since the first rate decrease in September 2007, the Federal Reserve has decreased rates more than 5.0 percentage points to less than 0.25 percent as of mid-December 2008. The Federal Reserve noted in its December press release that since October 2008, labor market conditions have deteriorated, and the available data indicate that consumer spending, business investment, and industrial production have declined. Financial markets remain quite strained and credit conditions tight. Overall, the outlook for economic activity has weakened further. Inflationary pressures have diminished appreciably and are expected to continue to moderate. The Federal Open Market Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time.


.16 The EESA is intended to restore financial sector liquidity and stability, protect the value of taxpayer assets (such as homes, savings, and retirement funds), and provide a return to taxpayers. The EESA authorizes the U.S. Treasury secretary to establish the Troubled Asset Relief Program (TARP), whereby the U.S. Treasury can purchase troubled assets from financial institutions, and authorizes $700 billion, as requested by the Treasury secretary for the implementation of TARP. Upon authorization of TARP, up to $350 billion became available for immediate use. The secretary is required to examine the long term viability of an institution in determining whether to directly purchase assets under TARP. Financial institutions participating in TARP will be subject to certain restrictions on executive compensation.

.17 At the time this alert was written, the U.S. Treasury had not acquired any assets under TARP, but the U.S. Treasury had released the terms of its Capital Purchase Program (CPP) and finalized certain transactions under the CPP. Under the CPP, the U.S. Treasury proposed to invest up to $250 billion in senior perpetual preferred stock and warrants in qualifying financial institutions. In November 2008, the U.S. Treasury completed its $125 billion aggregate investment in the 9 banking organizations deemed to be systemically important. An institution’s tier 1 capital will include, without limitation, funds received from the CPP. Other institutions were required to apply to their appropriate federal banking agency by November 14, 2008, for participation in the program. The deadline for nonpublic stock institutions and mutual banks has been extended as the U.S. Treasury develops term sheets applicable to these institutions.

.18 In summary, the primary components of the EESA include (a) an allocation of $700 billion to stabilize the U.S. financial system; (b) the creation of an oversight board, executive compensation rules, and other corporate governance rules for any entities that participate; (c) an increase of the statutory limit on public debt from $10.0 trillion to $11.3 trillion; (d) a temporary increase of Federal Deposit Insurance Corporation (FDIC) insurance limits; (e) the creation of a tax modification for Fannie Mae and Freddie Mac stock losses; (f) a restatement of the Securities and Exchange Commission’s (SEC’s) authority to suspend the application of Financial Accounting Standards Board (FASB) Statement No. 157, Fair Value Measurements; and (g) the requirement of the SEC to conduct a study on the impact of FASB Statement No. 157. The results of this study are discussed in subsequent sections of this alert.

.19 For additional information on the EESA and its related programs, see http://treasury.gov/initiatives/eesa/. On that Web site, you also may sign up for EESA e-mail alerts to receive notification about current developments.

Industry Trends and Conditions

Continuing Market Stress

.20 The prior year edition of this alert discussed a number of issues in fixed-income markets during the second half of 2007, beginning with effects on subprime mortgage-backed securities and extending to asset-backed commercial paper. During 2008, these markets continued under severe stress, to the extent that they placed significant stress on financial markets in general. A number of major financial institutions significantly exposed to distressed sectors of the markets were hit hard, most dramatically demonstrated by the absorption of Bear Stearns Companies Inc. by JPMorgan Chase & Co.; additional support provided by the federal government to Fannie Mae and Freddie Mac; the FDIC’s seizure of IndyMac Bank, a major mortgage originator, in July 2008; and the failure of Lehman Brothers, AIG, and two smaller banks. Further, several major commercial banks experienced significant financial weakening, and their stock values have fallen by two-thirds or more since December 2007. Many commercial and investment banks have either completed or have stated that they are contemplating stock issuances or asset sales to replenish capital depleted by significant losses.
Additional stress was placed on the markets when the credit ratings of major “monoline” bond insurers, including MBIA Inc. and Ambac Financial Group, Inc., were downgraded by the major rating agencies from their previous AAA levels, due to significant exposure to losses from insurance written on asset-backed securities. Certain less significant insurers experienced rating declines to “below-investment-grade” (or “junk”) status. This, in turn, resulted in the extension of market illiquidity to municipal and other corporate securities, for which bond insurance plays an integral role.

Beginning in February 2008, numerous auctions failed because of the losses and capital reductions incurred by market makers in auction-rate debt and preferred stock and, to a lesser extent, questions about the financial strength of bond insurers who supported the credit of certain auction-rate security issuers. These markets continue to struggle as of the writing of this alert. As a result, some municipal bond issuers paid unusually high interest rates, as required by their bond indentures in the event of failed auctions. Many of those issuers, however, have refinanced their debt with other issues. In addition, many closed-end investment companies also were significant issuers of auction-rate securities. Although they were not forced to pay the same punitive rates as other issuers, a number of fund groups also have refinanced their securities. See the “Legislative and Regulatory Developments” section of this alert for a discussion of tax and regulatory relief granted to those funds as part of their refinancing efforts.

This distress also found its way into the broader corporate loan and bond markets, with financial institutions reducing funds available for lending and tightening lending standards. At times, this resulted in the withdrawal of commitments to provide loans intended for corporate acquisitions and refinancings. Further, defaults among bond issuers generally have increased. Standard & Poor’s reported that, through November 11, 2008, 85 companies worldwide defaulted on their debt, affecting a total of $284 billion. This is a significant increase from the previous 2 years (22 defaults in 2007 and 30 in 2006). Of the 85 companies, 70 are based in the United States.

Finally, significant questions arose regarding the procedures used by bond rating agencies to evaluate asset-backed securities, in particular “AAA” ratings granted to securities, including securities acquired by SEC-registered money market funds (MMFs) that later experienced significant credit-related deterioration. As a result, the SEC has reconsidered the inclusion of specific references to ratings by nationally recognized statistical rating organizations (NRSROs) in its rules and forms out of concern that doing so (as stated in SEC communications) “has, in effect, placed an ‘official seal of approval’ on ratings that could adversely affect the quality of due diligence and investment analysis.” The SEC also has proposed a number of amendments to “reduce undue reliance on credit ratings and result in improvement in the analysis that underlies investment decisions.”

Legislative and Regulatory Developments

SEC Concerns

Disclaimer: A summary of financial statement review comments issued by the SEC staff (the staff) to investment company registrants and other guidance related to issues encountered by SEC registrants follows. These comments were compiled by the AICPA Investment Companies Expert Panel and have not been approved or endorsed by the SEC or its staff. This is not intended to be a comprehensive list.

Fund Marketing Materials

The staff expressed concern about instances when fund marketing materials on the registrant’s Web site are not consistent with information submitted in SEC filings, such as registration or financial statements. In one instance, a closed-end fund had disclosed its distribution rate on its Web site without providing any explanatory context about its composition. This registrant had distributions that related to return of capital and capital gains in the year disclosed. In another instance, a registered fund disclosed expense ratios on its Web site that were calculated based on methods that were not consistent with the instructions provided in Form N-1A or Form N-2 (the forms) or generally accepted accounting principles (GAAP) requirements (for example, expense ratio was based on average total assets rather than average net assets or calculations...
excluded certain expenses, such as interest expense). Registrants should ensure that marketing materials on their Web sites are consistent with information included in SEC filings and that financial information disclosed is consistent with the forms and GAAP.

Disclosures of Credit Support in Financial Statements of Registered Money Market Funds

.27 A number of publicly available no-action letters have been issued over the past year relating to support agreements provided to MMFs that experienced asset deterioration. These letters describe the obligation of an affiliate to guarantee payment of any scheduled principal and interest payments that are not made, including the principal and final interest payment for a security or group of securities that a money market fund is holding. The guarantee may be supported by the sponsor by obtaining a letter of credit from a highly rated financial institution that has a credit rating comparable to other eligible money market investments, if the sponsor itself does not have such a rating. Additionally, the term of the agreements typically is limited to the maximum term permitted (397 days) for an eligible nongovernment security under Rule 2a-7, “Money Market Funds,” under the Investment Company Act of 1940. Under such arrangements, MMFs bear no costs relating to the support agreements. The no-action letters can be accessed at www.sec.gov/divisions/investment/im-noaction.shtml#chron.

.28 Rule 2a-7 of the Investment Company Act of 1940 provides valuation guidance for registered MMFs. The rule places certain investment restrictions on MMFs that would minimize the impact of valuation volatility of their underlying asset portfolios. Accordingly, MMFs generally invest in short term investments, including certificates of deposit, commercial paper, and government securities and pay dividends to shareholders that generally reflect short-term interest rates. Although credit losses in the underlying portfolio of MMFs are possible, MMFs typically are managed with the goal of keeping losses to a minimum.

.29 Some MMFs sought to increase yields by investing in highly rated, short term debt tranches issued by structured investment vehicles (SIVs), which hold higher yielding securities. During the past year, events in the credit markets created situations in which the short term debt issued by certain SIVs could not be reissued due to concerns about some of the assets the SIVs held, causing buyers to be reluctant to purchase new paper. Additionally, in some cases, rating agencies downgraded SIV debt ratings due to asset concerns. The impact of these events left the SIVs in illiquid positions, and, in certain cases, the SIVs defaulted on their short term debt, resulting in further reductions in the market values of the SIVs’ securities. In certain situations, market value decline became so significant that it potentially could have resulted in MMFs’ noncompliance with Rule 2a-7 with respect to certain portfolio securities. Such noncompliance would have required MMFs to convert the valuation methodology followed for such portfolio securities from amortized cost to fair value, which would have caused the net asset value (NAV) per share to fluctuate from $1.00 and most likely fall below $1.00. To prevent the NAV from falling below $1.00, certain sponsors or investment advisors of MMFs intervened and provided some level of financial support to MMFs. This support included, but was not necessarily limited to, capital contributions, guarantees of value of specific investment securities (which may be supported through letters of credit), guarantees of principal of the overall funds, and agreements to purchase troubled securities at a value different than current market value (typically at amortized cost). The prospectuses of MMFs typically indicate that the shareholders in the MMFs are subject to the risk of loss of principal, and the sponsors or advisors of the MMFs do not commit, by contract or otherwise, to financially support the MMFs prior to the occurrence of any valuation event. The decision to provide additional financial support is made on a case-by-case basis when a specific MMF encounters difficulty.

.30 As a result of the credit crisis, during the later part of 2007 and throughout 2008, the SEC’s Division of Investment Management staff received requests from MMF registrants for regulatory relief to the extent the MMFs’ sponsors or advisors were willing to enter into financial arrangements with MMFs that were encountering valuation difficulties. In response, the SEC’s Division of Investment Management staff issued several no-action letters. These no-action letters provided relief to certain MMFs and their sponsors or advisors for situations in which the sponsors or advisors, at no cost to the MMFs, agreed to provide support for the benefit of the MMFs. This relief occurred if specific MMFs’ securities or identified group of securities (“security subject to credit support agreement”) failed to pay principal or interest as due or to the extent the
MMFs would be forced to sell the securities at a value less than amortized cost. The SEC’s Division of Investment Management staff has required that credit support agreements, consistent with Rule 2a-7’s maturity and quality requirements, have a short lifespan and that the credit support agreement providers either have a high credit standing or obtain a letter of credit from a financial institution with a high credit rating.

.31 To the extent an MMF receives some type of support agreement similar to those previously described, the MMF should present securities that are not subject to the credit support agreement(s) (and otherwise comply with the Rule 2a-7 guidelines) at amortized cost. Because the credit support agreement is considered to be a derivative, both the credit support agreement and the securities covered by it should be presented at fair value within the financial statements. Registrants should indicate, within the schedule of investments, which securities are subject to the agreement and that such securities are being carried at fair value. The existence and value of the credit support agreement should be identified separately on both the schedule of investments and the statement of assets and liabilities. Registrants also should refer to the note explaining the agreement.

.32 For the MMFs that have credit support agreements, the SEC staff noted that the fair value of the credit support agreement should offset the decline in fair value of those securities covered by the credit support agreement to ensure the MMF’s shadow priced NAV does not fall below the minimum NAV specified in the credit support agreement. The SEC staff indicated that they would expect to see, in plain English, the following disclosures relating to credit support agreements:

- Date of the agreement
- Entities that are parties to the agreement (including clear identification of any affiliated parties)
- Objectives of the agreement
- Triggering events for payments stipulated in the agreement (for example, sale of the security or determination by a court that full repayment will not occur)
- Terms of “backstop” provisions (that is, provisions requiring, upon maturity of the agreement, that the MMF sell or otherwise dispose of the securities involved, triggering payment under the agreement)
- Specific securities subject to the credit support agreement and their fair value and amortized cost as of reporting date
- Date of termination of the credit support agreement
- Fair value of the credit support agreement at the reporting date
- Credit standing of the counterparty providing the credit support agreement (as noted, the expectation is that this counterparty will have high credit standing)
- Disclosure on the schedule of investments of which securities are carried at fair value (that is, not at amortized cost)
- Disclosure on the schedule of investments of nonincome producing securities and securities that made partial principal or interest payments
- Change in unrealized appreciation or depreciation for the securities subject to the credit support agreement (to be presented in the statement of operations)
- Change in unrealized appreciation or depreciation on the credit support agreement (to be presented as a separate line item on the statement of operations under the caption “change in unrealized appreciation (depreciation) from affiliates”)
- Realized gain or loss, if any, relating to the credit support agreement (to be presented separately on the statement of operations)
Payments received and credit enhancements provided through the credit support arrangements should be presented consistent with the guidance provided in chapter 7 of the 2008 AICPA Audit and Accounting Guide Investment Companies (2008 guide), including disclosure in the financial highlights of the effect on total return of the payment or credit enhancement.

The staff indicated that many of the disclosure requirements previously described were derived from FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, and FASB Statement No. 57, Related Party Disclosures. The staff also indicated that these disclosures should be placed in a separate, readily identifiable, easy-to-understand footnote to the financial statements and should not be placed within another note (such as a valuation policy or related party transactions note). MMFs should avoid copying language directly from the credit support agreement into the notes to the financial statements.

Finally, the staff described additional disclosures that should be considered when an MMF holds securities affected by the credit crisis, even if not covered by a support agreement, no defaults exist, and NAV is not dramatically impaired:

- Disclosures about credit quality required by FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments
- Disclosures relating to risk concentrations of investments in the real estate or affected financial services industries (or in SIVs), as described in FASB Statement No. 107 and Statement of Position (SOP) 94-6, Disclosure of Certain Significant Risks and Uncertainties (AICPA, Technical Practice Aids, ACC sec. 10,640)

For more information, please refer to the AICPA Investment Companies Expert Panel meeting highlights posted on the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_investco.htm.

Questions Relative to FASB Statement No. 157 and Form N-Q Disclosures

The staff has questioned instances when registered investment companies excluded disclosures required by FASB Statement No. 157 from their Form N-Q, “Quarterly Schedule of Portfolio Holdings of Registered Management Investment Company,” filings. The staff noted that it was appropriate to include all disclosures required by FASB Statement No. 157 that are applicable to interim reporting periods, including the required roll-forward of assets and liabilities valued using unobservable, level 3 inputs when a registered investment company engages in a significant number of transactions in items valued using level 3 inputs or holds a significant number of level 3-valued investments throughout the reporting period. The staff indicated that Form N-Q refers to Rule 12b-20, “Additional Information,” of the Securities and Exchange Act of 1934, which states that a registrant should include additional information to avoid making the schedule misleading.

Seed Financial Statements and Recoupment Plan

The staff noted that a closed-end fund recently restated its seed financial statements because it failed to record a liability to the adviser under a recoupment plan. The staff stated that the note disclosure accompanying the seed financial statements indicated that the adviser will recoup organization costs after a specified period of time. Unlike traditional recoupment plans in which uncertainty exists about whether a fund’s net assets will increase to a level that will permit repayment and not exceed a predefined expense cap, it was probable that the adviser would recoup fees from the fund after a specified period of time.

Business Development Company Accounting for Income Tax Expense

The SEC staff noted that a business development company (BDC) restated its financial statements for improper accounting for income tax expense. Although the BDC elected to qualify under Subchapter M of the IRC, the BDC accrued a deferred tax liability related to the unrealized appreciation of portfolio securities. The deferred tax liability had been recorded by the BDC due to its perceived uncertainty surrounding the
ability to maintain its qualification. Chapter 6 paragraph .04 of the 2008 guide states, “Income tax expense related to net investment income and net realized gains on investments should be recorded when it is probable that an investment company subject to Subchapter M of the IRC will not qualify under that subchapter. Management should consider the need for recording a deferred tax expense if management concludes it is probable that the investment company will not meet its qualification requirements for a period longer than one year.” The SEC staff questioned whether the BDC should have recorded a deferred tax liability given the BDC’s history of qualification under Subchapter M and its intent to continue to qualify under Subchapter M. The BDC ultimately concluded that the deferred tax liability was not appropriate and restated its financial statements to correct the error.

.40 The staff further noted an instance when one open-end fund chose not to comply with Subchapter M of the IRC and, therefore, elected to be taxed as a corporation. However, this registrant did not accrue any deferred tax liabilities on the net unrealized appreciation of portfolio securities, as required under FASB Statement No. 109, Accounting for Income Taxes. The registrant made a correction by recognizing the deferred tax liabilities, in accordance with FASB Statement No. 109.

SEC Developments

Results of SEC Study on Fair Value Accounting

.41 As described in the EESA discussion, the SEC was required to conduct a study on the impact of FASB Statement No. 157, which was released on December 30, 2008. This study helped the SEC determine whether to exercise their right to suspend FASB Statement No. 157, which they decided not to do. The study was focused on the impact of FASB Statement No. 157 on financial institutions’ balance sheets, bank failures in 2008, the quality of financial information available to investors, the process used by FASB in developing accounting standards, and alternative accounting standards to FASB Statement No. 157. As noted in the EESA section requiring this study, the EESA restated the SEC’s right to suspend the application of FASB Statement No. 157. Many constituents communicated with the SEC about this possible suspension, and these responses contained a wide range of opinions on the matter. Additionally, comment letters to the SEC also have been issued on the issuance of FASB Staff Position (FSP) FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active.

.42 The study does recommend improvements to existing practice, including reconsidering the accounting for impairments and the development of additional guidance for determining fair value of investments in inactive markets, including situations in which market prices are not readily available.

.43 The highlights of the report include the following six findings related to the key EESA-mandated topics and eight recommendations by the SEC staff:

- First, in regard to the effect of fair value accounting standards on financial institutions’ balance sheets, the SEC staff observed that fair value measurements were used to measure a minority of the assets and liabilities included in financial institutions’ balance sheets. However, these fair value measurements did significantly affect financial institutions’ reported income.
- Second, in regard to the impact of fair value accounting on bank failures in 2008, the SEC staff observed that fair value accounting did not appear to play a significant role.
- Third, in regard to the impact of fair value accounting on the quality of financial information available to investors, the SEC staff noted investors generally support measurements at fair value. However, many investors also indicated the need for improvements to existing fair value standards.
- Fourth, the report confirmed that FASB, as an independent accounting standard setter, is best positioned to develop neutral accounting guidance. However, steps could be taken to enhance the existing process in terms of timeliness and transparency.
- Fifth, the SEC staff found that suspending FASB Statement No. 157 would lead to a reversion of practice and would likely increase investor uncertainty. Nonetheless, the issuance of additional guidance is advised.
Lastly, the SEC staff provided recommendations on the advisability and feasibility of modifications to existing accounting standards and related financial report requirements.

The eight key recommendations from the report are as follows:

- FASB Statement No. 157 should be improved but not suspended.
- Existing fair value and mark-to-market requirements should not be suspended.
- Additional measures should be taken to improve the application and practice related to existing fair value requirements (particularly as they relate to both level 2 and level 3 estimates).
- Accounting for financial asset impairments should be readdressed.
- Further guidance should be implemented to foster the use of sound judgment.
- Accounting standards should continue to be established to meet the needs of investors.
- Formal measures to address the operation of existing accounting standards in practice should be established.
- Accounting for investments in financial assets should be simplified.

The changes in fair value accounting standards and the FASB standard setting process that could occur due to the results of this report will be seen in the coming months and years. For the full text of the SEC report, visit www.sec.gov/news/studies/2008/marktomarket123008.pdf.

Temporary Exemption for Liquidation of Certain MMFs

On November 20, 2008, the SEC issued an interim final temporary rule with a request for comment. The interim final temporary rule was adopted under the Investment Company Act of 1940 to provide relief for MMFs that are participating in the temporary guaranty program established by the U.S. Treasury. The rule is effective from November 26, 2008, until October 18, 2009, unless terminated at an earlier date, as announced in the Federal Register. Early termination would be in conjunction with the loan guarantee program. The comment period ended December 26, 2008.

For more information on this rule, visit www.sec.gov/rules/final/2008/ic-28487.pdf.

Mutual Funds Regulatory Filings Will Be Available Online

On October 29, 2008, the SEC announced that it has adopted rule revisions that require mutual funds and other companies seeking exemptions under the Investment Company Act of 1940 to submit to file their applications electronically. The rule revisions enable investors to access these filings sooner; allow the SEC to consider them more quickly; and eliminate unnecessary administrative tasks for applicants, including the requirement that certain documents be notarized and that applicants submit a draft notice along with an application.

The rule revisions are effective January 1, 2009, for new or amended applications for orders under the Investment Company Act of 1940. Electronic filing also will become mandatory for Regulation E filings of small business investment companies and BDCs. For more information on this ruling, SEC Release No. 33-8981, visit www.sec.gov/news/press/2008/2008-257.htm.

“Naked” Short Selling Antifraud Rule

In October 2008, the SEC issued a final rule (SEC Release No. 34-58774) adopting an antifraud rule under the Securities Exchange Act of 1934 to address fails to deliver securities that have been associated with “naked” short selling. The rule, which is effective October 17, 2008, will further evidence the liability of short sellers, including broker-dealers acting for their own accounts, who deceive specified persons about their intention or ability to deliver securities in time for settlement (including persons that deceive their
broker-dealer about their locate source or ownership of shares) and that fail to deliver securities by the settlement date. The final rule can be accessed at www.sec.gov/rules/final/2008/34-58774.pdf.

**Disclosure of Short Sales and Short Positions by Institutional Investment Managers**

.51 In October 2008, the SEC released an interim final temporary rule with a request for comments titled “Disclosure of Short Sales and Short Positions by Institutional Investment Managers.” The rule requires certain institutional investment managers to file information on Form SH, “Weekly Report of Short Sales and Short Positions,” concerning their short sales and positions of Section 13(f) securities, excluding options. The rule extends the reporting requirements established by SEC Emergency Orders issued September 18, 2008; September 21, 2008; and October 2, 2008, with some modifications. The effective date is from October 18, 2008, until August 1, 2009. For more information on this rule, visit www.sec.gov/rules/final/2008/34-58785.pdf.

**SEC Proposes Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors With Respect to Investment Advisor Portfolio Trading Practices**

.52 On July 30, 2008, the SEC published for comment proposed guidance regarding the duties and responsibilities of investment company boards of directors with respect to investor advisor portfolio trading practices. The focus of the guidance is the role that an investment company board has in overseeing the execution of obligations by the investment advisor hired to invest in securities and other instruments on behalf of the investment company. Comments were due to the SEC by October 1, 2008. For more information, visit www.sec.gov/rules/proposed/2008/34-58264.pdf.

**Proposed Guidance to Fund Boards in Oversight of Investment Adviser Trading and Use of Soft Dollars**

.53 In a July 30, 2008, press release, the SEC proposed guidance to investment company boards of directors “about their investor protection responsibilities in overseeing investment advisers who trade fund portfolio securities and use so-called ‘soft dollars.’” The management of investment companies by investment advisers separate from the funds can present conflicts of interest between the fund and its investment adviser, which can lead to potential opportunities for abuse. These conflicts of interest include the use by advisers of soft dollars, which represent the assets of investors, to purchase research and other brokerage services as part of their obligation to seek best execution when it trades a fund’s securities.

Under the Investment Company Act of 1940 and state law, fund directors have important fiduciary responsibilities to oversee the safety of fund assets and the protection of investors. The SEC’s proposed guidance would help fund boards of directors to analyze whether to limit the adviser’s use of soft dollar arrangements.

“As the protectors of the interests of fund investors, fund boards play a pivotal role in monitoring the conflicts of interest that may arise when an investment adviser trades a fund’s portfolio securities,” said Andrew J. Donohue, Director of the SEC’s Division of Investment Management. “The importance of the board’s responsibilities in this area cannot be overstated. The [SEC’s] proposed guidance would provide directors a flexible framework to work within to ensure that conflicts are being managed and that fund assets are being used in the best interest of the fund and its shareholders.”

The SEC’s proposed guidance does not impose any new requirements on fund directors or investment advisers. Rather, it proposes a flexible framework for directors to use in their oversight of an adviser’s trading activities. Specifically, the guidance suggests information for a fund board to request from an investment adviser in order to determine whether the adviser is managing any conflicts and using fund assets in the best interests of the fund.

**SEC Actions to Rein in the Role of Ratings**

During June and July 2008, the SEC took three distinct actions relative to NRSROs. First, the SEC issued a proposed rule on June 16, 2008 (SEC Release No. 34-57967), to “impose additional requirements on NRSROs in order to address concerns about the integrity of their credit rating procedures and methodologies in the light of the role they played in determining credit ratings for securities collateralized by or linked to subprime residential mortgages.” Second, the SEC issued “a proposal related to structured finance products rating symbology.”

Finally, on July 1, 2008, the SEC issued a proposed rule (SEC Release No. 34-58070 and IC-28327) to amend various rules and forms under the Securities Exchange Act of 1934 that rely on NRSRO ratings. The proposed rule is designed to address concerns that the reference to NRSRO ratings in SEC rules and forms may have contributed to an undue reliance on NRSRO ratings by market participants. This proposal specifically addresses references to rating agencies in the following various rules under the Investment Company Act of 1940 and Investment Advisers Act of 1940:

- Rule 2a-7 is proposed to be significantly amended as follows:
  - The requirement that any security be in the two highest rating agency classifications in order to be deemed to have “minimal credit risk” to be eligible for acquisition by a money market fund is replaced by a determination by the fund’s board of directors of “minimal credit risk”; although credit ratings can be considered in the determination, the assessment must be made independently.
  - A requirement that an adviser promptly notify the board of any information suggesting that a security held by a money market fund may not continue to present “minimal credit risk” and that the board evaluate the continued holding of the security based on that notification, rather than predating the board evaluation on a rating agency downgrade as currently provided in Rule 2a-7.
  - An explicit regulation codifying the SEC staff’s position that a money market fund may not acquire illiquid securities if such acquisition would cause the fund’s illiquid holdings to exceed 10 percent of total assets. If changes in the liquidity status of individual securities or shareholder redemptions caused existing illiquid holdings to exceed the 10 percent level, the rule would require a money market fund to take steps to bring the aggregate amount of illiquid securities back within the 10 percent limitation as soon as reasonably practicable. However, this requirement generally would not force a money market fund to dispose of any portfolio security if such sale would cause the fund to suffer a loss.
  - A requirement that a money market fund promptly inform the SEC when an affiliate of the fund purchases a security that is no longer “eligible,” in accordance with Rule 17a-9, “Purchase of Certain Securities From a Money Market Fund by an Affiliate, or an Affiliate of an Affiliate,” under the Investment Company Act of 1940.

- Rule 3a-7, “Issuers of Asset-Backed Securities,” which is the exemptive rule for certain structured financings under the Investment Company Act of 1940, is proposed to be modified to remove references to ratings downgrades and change the safekeeping provisions.

- Rule 5b-3, “Acquisition of Repurchase Agreement or Refunded Security Treated as Acquisition of Underlying Securities,” of the Investment Company Act of 1940 is proposed to be modified to replace the requirement that repurchase agreements acquired by a fund as investments, if not collateralized by cash or government securities, be fully collateralized by securities rated in the highest rating category by a rating agency with a requirement that the fund’s board determine that the securities are sufficiently liquid that they can be sold at or near their carrying value within a
reasonably short period of time, are subject to minimal credit risk, and are issued by a person who has the highest capacity to meet the fund’s financial obligations.

- Rule 5b-3 also permits a fund to consider the purchase of “refunded” securities to be the acquisition of escrowed government securities for SEC diversification requirements if the securities satisfy certain conditions (for example, independent CPA certification to the escrow agent that the escrowed securities will satisfy all scheduled payments of principal, interest, and applicable premiums on the refunded securities). In the current rule, this certification condition is not required if the refunded security has received a debt rating in the highest rating category from an NRSRO. The proposed modification, however, would eliminate the exception to the certification requirement for securities that have received the highest rating from an NRSRO.

- Rule 10f-3, “Exemption for the Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate,” of the Investment Company Act of 1940 is proposed to be modified to replace the provisions that permit the acquisition of municipal securities from an underwriting syndicate of which an affiliate of the fund is a member, if the security had received an investment grade rating from a rating agency, with a determination that the securities could be resold at or near their fair value within a short period of time and that they have no greater than moderate credit risk. This proposal, however, would place no greater responsibilities on a mutual fund board than it already has to review affiliated transactions under Rule 10f-3.

- Rule 206(3)-3T, “Temporary Rule Regarding Principal Trades with Certain Advisory Clients,” of the Investment Advisers Act of 1940, is proposed to be modified to replace the provisions, paralleling those of the aforementioned Rule 10f-3, that currently permit an adviser registered as a broker-dealer to trade with a client in a principal capacity for any nonconvertible fixed income security (not only municipal securities) rated “investment grade” by a rating agency.

.57 The comment period for this proposal ended September 5, 2008.

Revisions to Mutual Fund Disclosure

.58 In late July 2008, the SEC reopened the public comment period on a previously proposed rule regarding improved mutual fund disclosure (SEC Release No. 33-8949). In November 2007, the SEC proposed rule changes that would require that all mutual fund investors receive a clear, concise summary of key information needed to make an informed investment decision. The rule changes also would encourage funds to harness the power of the Internet to allow investors to choose the format in which they receive more detailed information and provide that information in a more user-friendly format than is available today. The proposed rules are intended to enable investors to use and compare mutual fund information more effectively.

.59 Summary Information at the Front of the Prospectus. The proposal would amend Form N-1A, the form used by mutual funds to register under the Investment Company Act of 1940 and offer securities under the Securities Act of 1933, by requiring every mutual fund to include key information in plain English in a standardized order at the front of the mutual fund statutory prospectus. Like the risk/return summary that is currently included at the front of every mutual fund prospectus, this summary would include a fund’s investment objectives and strategies, risks, performance, and costs. It also would include brief information regarding the top 10 portfolio holdings, investment advisers and portfolio managers, procedures related to the purchase and sale of the fund’s shares and tax information, and financial intermediary compensation. The proposed amendments would require that the summary information be presented separately for each fund covered by a multiple fund prospectus. This requirement is intended to assist investors in finding important information regarding the particular fund in which they are interested.

.60 New Prospectus Delivery Option for Mutual Fund Securities. The proposed rule would permit a person to satisfy the rule’s mutual fund prospectus delivery obligations under the securities laws by sending or giving key information to investors in the form of a “summary prospectus” and providing the summary prospectus, statutory prospectus, shareholder reports, and other information on a Web site in a format that enhances the investors’ ability to effectively use the more detailed information in those documents. In
addition, the statutory prospectus and other information would be provided in paper to any investor who prefers to review more detailed information in that format. The summary prospectus would contain the same information in the same order as the required summary at the front of the statutory prospectus.

The proposed rule would require that the Internet version of the summary prospectus and statutory prospectus be presented in a user-friendly format that permits investors, financial intermediaries, analysts, and other users to easily move back and forth between related information in the summary prospectus and the statutory prospectus. This is intended to allow investors and others to efficiently access the particular information in which they are interested. The proposed rule also would require that persons accessing the Internet information be able to permanently retain an electronic version of the summary prospectus, statutory prospectus, and other information. The proposal is intended to take advantage of technological developments and the expanded use of the Internet in order to provide investors with information that is easier to use and more readily accessible, but still retains the comprehensive quality of the information that is available to investors today.

The SEC reopened the public comment period, which ended August 29, 2008, on this proposal in order to allow comments based on the results of focus group testing and a telephone survey of investors. The full text of the proposed rule is available at www.sec.gov/rules/proposed/2008/33-8949.pdf.

On November 19, 2008, the SEC approved final rules effective February 28, 2009, which require funds to begin complying with the form changes by January 1, 2010. The full text of the final rules has not been issued as of the writing of this alert.

SEC Action to Facilitate Refinancing of Closed-End Auction-Rate Preferred Stock

On June 13, 2008, the SEC issued a no-action letter, and the IRS, in a parallel notice, provided regulatory relief to facilitate the refinancing of auction-rate preferred stock, which had been subject to the failure of the auction markets earlier in the year.

In the SEC no-action letter, an advisor of closed-end investment companies received regulatory relief from the SEC staff for a type of stock called liquidity protected preferred (LPP) shares, which, similar to auction-rate preferred stock, would have its dividend rate reset periodically in a remarketing process. However, unlike auction-rate preferred stock, LPP would be offered with the unconditional obligation of a liquidity provider, with a requisite minimum short term rating, to purchase any LPP subject to sell orders that had not been matched by purchase orders in a remarketing. Additionally, upon failed remarketing, additional terms would take effect, including escalating dividend rates; additional fees to the liquidity provider; and “puts” of the security to the issuing fund or, in the initial LPP offering, the advisor. In their response, the staff of the SEC’s Division of Investment Management agreed not to recommend enforcement action if SEC-registered MMFs purchased LPP, so long as the MMFs otherwise comply with the requirements of Rule 2a-7. The Division of Corporation Finance agreed not to recommend enforcement action if the closed-end funds, the liquidity provider, or any other person reacquired LPP without complying with the tender offer rules under the Securities Exchange Act of 1934. Further, the staff agreed that the liquidity and “put” features of the LPP would not cause the LPP to be classified as a “redeemable security” under Section 2(a)(32) of the Investment Company Act of 1940. The no-action letter is available on the “Investment Management” section of the SEC’s Web site at www.sec.gov/divisions/investment/noaction/2008/eatonvance061308.pdf.

The IRS, in Notice 2008-55, Auction Rate Preferred Stock—Effect of Liquidity Facilities on Equity Character, provided guidance on the effect of adding liquidity facilities to support certain auction-rate preferred stock. Explicitly stating that the notice provided “administrative relief in furtherance of public policy in light of significant liquidity needs in the auction rate securities market as a result of recent significant auction failures in this market,” the IRS noted that it would not challenge the equity characterization of certain auction-rate preferred stock issued by closed-end investment companies and supported by a liquidity facility under the following conditions:
• The preferred stock either must have been outstanding on February 12, 2008, the date on which significant auction failures first occurred, or issued after that date to either directly or indirectly refinance auction-rate preferred stock outstanding on that date. Further, the amount of preferred stock issued under a refinancing cannot exceed the previously outstanding preferred stock’s liquidation preference.

• The liquidity facility must either be an initial facility entered between February 12, 2008, and December 31, 2009, or a facility that replaces, renews, or extends such an initial facility. Additionally, the liquidity facility cannot be “related” to the adjustable-rate preferred issuer.

• The closed-end fund invests predominantly in debt instruments, and other investments are incidental to its business of investing in the debt instruments.

• Dividends paid must be declared and paid out of legally available funds, as provided under applicable state law.

• The obligation of the liquidity provider to repurchase preferred stock is triggered only if an auction or remarketing fails or if an existing liquidity facility is not renewed, replaced, or extended with the same or another provider by a date that occurs at least two auction or remarketing dates before the stated expiration date of the existing facility.

• The right of the liquidity provider to have the preferred stock redeemed cannot be exercisable until the preferred stock has been held by the liquidity provider for at least six months and good-faith efforts have been made to resell the shares in periodic auctions at a price equal to the liquidation preference plus accrued but unpaid dividends. Additionally, any redemption right must comply with any applicable state law restrictions on redemption of the shares.

.67 Finally, in October 2008, a closed-end investment company adviser and 5 funds managed by the adviser received an order of exemptive relief with the SEC under Section 6(c) of the Investment Company Act of 1940. The order permits the adviser, for a period of 2 years immediately following the date of the order, to issue a class of senior securities representing indebtedness and redeem its issued and outstanding auction rate preferred shares. The adviser also may declare dividends or other distributions on its capital stock. The issuance of the senior securities is subject to the 200 percent asset coverage rule. For more information, visit www.sec.gov/rules/ic/2008/ic-28464.pdf.

Interactive Data to Improve Financial Reporting

.68 In December 2008, the SEC voted to require public companies and mutual funds to use interactive data for financial information. Companies will provide their financial statements to the SEC and on their corporate Web sites in interactive data format using the eXtensible Business Reporting Language (XBRL). This will allow investors to use interactive data to receive important information in a fast, more reliable manner at a reduced cost. In the past, companies voluntarily filed SEC financial information in interactive data format.

.69 This approval requires that for public companies other than mutual funds, interactive data financial reporting will occur on a phased-in schedule beginning in 2009. In its December 18, 2008, press release, the SEC stated that the largest companies who file using U.S. GAAP with a public float above $5 billion (approximately 500 companies) will be required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2009. The remaining companies who file using U.S. GAAP will be required to file with interactive data on a phased-in schedule over the next 2 years. Companies reporting in International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) will be required to provide their interactive data reports starting with fiscal years ending on or after June 15, 2011. Companies can adopt interactive data earlier than their required start date. All U.S. public companies will have filed interactive data financial information by December 2011 for use by investors.

.70 The SEC further noted in its press release that “[m]utual fund investors will begin reaping the benefits of interactive data starting in 2011. Mutual funds will be required to begin including data tags in their public
filings that supply investors with such information as objectives and strategies, risks, performance, and costs. A mutual fund also would be required to post the interactive data on its Web site, if it maintains one.”

.71 The full text of the SEC’s press release is available at www.sec.gov/news/press/2008/2008-300.htm. At the time of this writing, the final rule was not yet available. The proposed rules, on which the final rule is based, are available on the SEC’s Web site (SEC Release Nos. 33-8924 and 33-8929).

SEC Broadens Opportunities for Small Business Financing

.72 On May 15, 2008, the SEC broadened small business financing opportunities available to BDCs by amending Rule 2a-46, “Certain Issuers as Eligible Portfolio Companies,” under the Investment Company Act of 1940 to increase availability of capital to certain smaller companies that may not have access to public access markets or other forms of conventional financing.

.73 Rule 2a-46 was amended to expand the definition of eligible portfolio company to include any domestic operating company with securities listed on a national securities exchange if the company has a market capitalization of less than $250 million on any day in the 60-day period immediately before the BDC’s acquisition of its securities. The amendment is intended to improve opportunities for investors and small businesses and contribute directly to the nation’s capital markets.

.74 The amendment is effective July 21, 2008. The full text of the release concerning this rule amendment is available at www.sec.gov/rules/final/2008/ic-28266.pdf.

Disclosure of Divestment by Registered Investment Companies in Accordance With the Sudan Accountability and Divestment Act of 2007

.75 The SEC issued a final rule in April 2008 that would amend the forms used under the Securities Exchange Act of 1934 and the Investment Company Act of 1940. The final rule requires disclosure by a registered investment company that divests certain securities in accordance with the Sudan Accountability and Divestment Act of 2007 (SADA).

.76 The SEC final rule requires each registered investment company that divests securities in accordance with the SADA to disclose the divestment on the next Form N-CSR, “Certified Shareholder Report of Registered Management Investment Companies,” or Form N-SAR, “Semi-Annual Report for Registered Investment Companies,” that it files following the divestment. The SEC final rule states the disclosures include the following:

• The issuer’s name
• Exchange ticker symbol
• Committee on Uniform Securities Identification Procedures (CUSIP) number
• Total number of shares or, for debt securities, principal amount divested
• Date the securities were divested

.77 If the registered investment company continues to hold any securities of the divested issuers, it will be required to disclose the exchange ticker symbol; CUSIP number; and total number of shares or, for debt securities, principal amount of such securities, held on the date of the filing. For purposes of determining when a divestment should be reported, if a registered investment company divests its holdings in a particular security in a related series of transactions, the company may deem the divestment to occur at the time of the final transaction in the series. For more information, please visit www.sec.gov/rules/final/2008/34-57711.pdf.
No-Action Letter Related to Consolidation of a Nonregistered Investment Company Subsidiary

.78 In response to a request from the Fidelity Select Portfolio, the SEC staff indicated it would not recommend enforcement action to the SEC against Gold Portfolio, a series of Fidelity Select Portfolio, a registered investment company and business trust organized under the laws of the Commonwealth of Massachusetts, under Rule 6-03(c)(1), “Special Rules of General Application to Registered Investment Companies,” of Regulation S-X with respect to Gold Portfolio’s proposed consolidation of its financial statements with those of its wholly-owned subsidiary, Fidelity Select Gold Cayman Ltd., a Cayman Islands limited company (the subsidiary). Rule 6-03(c)(1) of Regulation S-X is interpreted to mean that a registered investment company may consolidate its financial statements only with a subsidiary that is another registered investment company. The no-action relief request stated that it would be appropriate to consolidate the financial statements of the subsidiary into Gold Portfolio because (1) it would give shareholders a more accurate picture of Gold Portfolio and its financial position, structure, and investment strategies and (2) would more fully reflect the fact that the sole purpose of the subsidiary is to serve as a vehicle through which Gold Portfolio gains exposure to particular commodities.

.79 The subsidiary was established as a nonregistered investment company in response to restrictions placed on registered investment companies to invest in commodities and commodity-linked investments. Section 851(b)(2) of the IRC states, in relevant part, that a corporation shall not be considered a regulated investment company for any taxable year unless, among other things, at least 90 percent of its gross income is derived from “dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended) or foreign currencies or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies” or from net income of certain publicly traded partnerships. In order to gain significant exposure to these instruments, Gold Portfolio obtained a ruling from the IRS that concluded that income arising from investments in certain foreign corporations (that is, corporations that are “controlled foreign corporations” for purposes of the IRC) that invest in commodities and commodities-linked investments constitutes qualifying income.

.80 The SEC staff noted Gold Portfolio formed the subsidiary, which is authorized to invest in commodities, commodities-linked instruments, and derivatives and commodity exchange-traded funds, with the purpose “to serve as a vehicle through which its corresponding Fidelity Fund may gain investment exposure to commodities in a manner consistent with the IRS Ruling. As a result of Gold Portfolio’s investment in Gold Subsidiary, Gold Portfolio could receive income derived from commodities, such as gold, to a greater extent than otherwise permitted by Subchapter M had Gold Portfolio invested in the commodities directly.” The request for no-action relief included a representation that Gold Portfolio would limit its investment in the subsidiary to 25 percent of Gold Portfolio’s assets at the end of each quarter and that the subsidiary would operate in many respects as an investment company, including accounting for the subsidiary’s holdings using the fair value basis of accounting.

.81 The SEC staff further noted that different facts or representations may require a different conclusion and that the no-action letter response expresses the position of the Division of Investment Management on enforcement only and does not purport to express any accounting or legal conclusions on the issues presented. The full text of the SEC no-action letter is available at www.sec.gov/divisions/investment/noaction/2008/fidelity042908.htm.

Commodity Futures Trading Commission Developments

.82 Investment companies that trade commodity futures or options on futures contracts are subject to the regulations of the Commodity Futures Trading Commission (CFTC). Those regulations impose certain financial reporting requirements, including, in some cases, requiring that an entity’s annual financial report be audited. The following section summarizes certain CFTC and other regulatory guidance issued or planned to be issued affecting 2008 financial statements. Any regulation changes will be published in the
Federal Register, and they, along with the following items, can be accessed electronically from the CFTC Web site at www.cftc.gov/.

CFTC Annual “Dear CPO” Letter

.83 On January 16, 2008, the CFTC staff issued its annual letter to commodity pool operators (CPOs) outlining key reporting issues and common reporting deficiencies found in annual financial reports for commodity pools. The CFTC anticipates issuing a similar letter in January 2009. The letter emphasized the CFTC staff’s concerns and, accordingly, may alert the auditor to high risk issues that could affect assertions contained in the financial statements of commodity pools. The CFTC staff suggested that CPOs share the letter with their independent auditors.

.84 The letter addresses the following concerns:

- Due dates of commodity pool financial filings for late filings
- Complex entities
- Requests for limited relief from U.S. GAAP compliance for certain offshore commodity pools
- Initial and final annual reports
- Other filings by CPOs regarding the following:
  - Replacement of an accountant
  - Election of fiscal year
  - Regulation 4.13 exemptions
- Accounting developments, including the following:
  - FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, implementation and its impact on participants’ redemptions
  - Alternative investments and audit considerations
  - AICPA technical guidance regarding offering costs
  - FASB Statement No. 157
- Recent regulatory development affecting CPOs


.86 The CFTC has issued similar letters in prior years, which are available on its Web site. According to the 2008 letter, those letters should be consulted with respect to commodity pool annual financial statements and reporting. Specifically relevant and still applicable information available in such prior letters includes the following:

- Reports for pools for the fiscal year in which an initial claim of exemption under Regulation 4.13 is filed (2006 CPO letter)
- Notice of replacement of accountant (2006 CPO letter)
- Notice regarding election of fiscal year other than calendar year (2006 CPO letter)
- Requests for confidential treatment of commodity pool annual reports (2006 CPO letter)
• AICPA SOP 95-2, Financial Reporting by Nonpublic Investment Partnerships (AICPA, Technical Practice Aids, ACC sec. 10,660), applicability to both required audited and unaudited commodity pool annual financial reports (2004 CPO letter)

.87 In addition, CFTC interpretations and other staff letters that provide written guidance concerning the Commodity Exchange Act and the CFTC’s regulations are available on the CFTC’s Web site. In particular, CFTC Interpretive Letter 94-3, Special Allocations of Investment Partnership Equity, addresses how a CPO should report a special allocation of partnership equity to the general partner or any other special class of participant of an investment partnership in the financial statements of a commodity pool.

Audit and Attestation Issues and Developments

Audit Risks Arising From Current Economic Conditions

.88 As previously discussed, we have experienced unprecedented events in the economy and financial markets in 2008 that will continue in 2009. These events undoubtedly will affect the audits you are performing. Recent economic conditions may cause additional risk factors that had not existed or did not have a material effect on audit clients in prior years. When obtaining an understanding of the external factors that affect the entity and the risks associated with those factors, the auditor may consider whether conditions exist that indicate risks of material misstatement. Some examples that relate to economic conditions are as follows:

• Constraints on the availability of capital and credit
• Going concern and liquidity issues
• Marginally achieving explicitly stated strategic objectives
• Use of off-balance-sheet financings, special-purpose entities, and other complex financing arrangements
• Operations that are exposed to volatile markets or in regions with economic volatility, including employment and housing issues
• Volatile real estate markets and the credit crisis, which result in significant measurement uncertainty, including accounting estimates and fair value measurements

.89 Although many of these risks are not new to business, consideration of the many ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks.

.90 Generally, many fixed income markets became extraordinarily illiquid in late 2008, resulting in a substantial increase in risk over the valuation assertion for virtually any kind of fixed income security of any duration. Also, concerns arose about the possibility of significant redemptions from various types of funds and reports of certain private funds either placing limits on redemptions, freezing the ability to redeem entirely, or determining to commence an orderly wind-down of operations. Thus, subsequent events, reporting considerations, and assessment of the going concern status of some investment companies take on added importance in the current environment as well. This section of the alert discusses a number of audit issues for you to consider in the current economic environment.

Investment Company Audit Risks Arising From Current Economic Conditions

.91 Auditors should consider the overall effect of risk on an entity’s portfolio of subprime mortgages and related investments (for example, asset-backed commercial paper or high-yield debt or loans). The auditor may consider the entity’s internal controls as well as policies that affect the management and monitoring of these investments. In particular, the auditor may consider the extent to which the entity analyzes the collateral supporting various asset-backed securities and whether the entity has enhanced its monitoring procedures in light of the deterioration in collateral that has been exhibited.
Auditors also should consider the increased difficulty of obtaining reliable valuations for certain types of asset-backed securities, given that the decrease in market liquidity experienced in 2007 and 2008 is likely to continue into 2009. Again, the auditor may consider the entity’s internal controls over valuation, in particular the extent to which the entity monitors valuations obtained from brokers and external pricing services for consistency with its own observations of market conditions. In addition, the auditor may consider the involvement of valuation committees or other internal review groups independent of portfolio managers in assessing the day-to-day reasonableness of security valuations and overriding quotations that appear to be unrepresentative. This is of equal importance for MMFs that are permitted to use the amortized cost valuation method only if the results are not materially different from those obtained by valuing securities using current market quotations.

To the extent either asset-backed or traditional fixed-income securities have experienced credit deterioration, the auditor may consider whether income that has been recognized as receivable on the securities remains collectible. The 2008 guide notes in chapter 2 paragraph .60, “In accordance with the guidance provided in FASB Statement No. 5, [Accounting for Contingencies], accrued interest should be written off when it becomes probable that the interest will not be collected and the amount of uncollectible interest can be reasonably estimated.” The 2008 guide also provides guidance on the accounting for expenditures made in support of defaulted debt securities. The disclosure requirements of FASB Statement No. 107 relating to concentrations of credit risk for all financial instruments also should be considered.

The auditor should consider the existence of financial covenants and the entity’s compliance with those covenants to the extent an investment vehicle has employed leverage. The auditor may obtain an understanding of management’s ongoing compliance monitoring process. If the vehicle is no longer in compliance with the covenants, the auditor should assess the appropriate accounting and reporting implications, including AU section 341, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern (AICPA, Professional Standards, vol. 1). A more detailed discussion of going concern follows.

The advisers or other sponsors of a number of registered and unregistered MMFs have either purchased distressed securities directly from the funds at their amortized cost (above current market value) or have entered into “credit support agreements” to enable the funds to continue to engage in shareholder transactions at a constant $1.00 per share NAV. Preparers and auditors of investment company financial statements should review chapter 7 paragraphs .56–.58 of the 2008 guide for accounting and disclosure guidance for payments made to an investment fund by affiliates. Additionally, the staff of the SEC Division of Investment Management has indicated their views for appropriate accounting and disclosure by MMFs for credit support agreements provided by affiliates, which are summarized in the “Legislative and Regulatory Developments” section of this alert.

A number of closed-end investment companies that had issued auction-rate securities refinanced those securities during 2008. Preparers and auditors should consider the tax and regulatory guidance summarized in the “Legislative and Regulatory Developments” section of this alert in assessing various financial reporting and auditing considerations. If an investment company has not refinanced its auction-rate securities and auctions continue to fail through the audit date, preparers and auditors should consider not only the direct financial reporting implications of those failures but also the potential implications of continued failures on compliance with the terms of any rating agency requirements and the governing documents under which the auction-rate securities were issued.

Additionally, some investment companies may have acquired as investments (assets) the auction-rate securities of various noninvestment company corporate or municipal issuers. Because the only organized market for transferring the securities was the auction market, it has been extremely difficult to sell or transfer these securities to third parties in recent months. If those securities are not redeemed through refinancing, they may remain in investment company portfolios. Several media reports have indicated that securities, to the extent limited trading has occurred, have traded at potentially significant discounts from the values that would have been received if orderly auctions had continued.
In certain instances, the auditor may need special skills or knowledge to plan and perform auditing procedures for institutions that deal with subprime mortgage-backed and other asset-backed securities. AU section 332, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities (AICPA, Professional Standards, vol. 1), states that “for some derivatives and securities, [GAAP] may prescribe presentation and disclosure requirements.” Furthermore, AU section 332 advises the auditor to consider the form, arrangement, and content of the financial statements (including the notes) when evaluating the adequacy of presentation and disclosure. Auditors also may consider using a specialist when determining how to audit an entity that deals in derivatives. AU section 336, Using the Work of a Specialist (AICPA, Professional Standards, vol. 1), provides guidance on the use of a specialist during an engagement and is discussed in more detail as follows.

Specific Issues as a Result of the Failure of Lehman Brothers

The failure of Lehman Brothers resulted in numerous issues relating to various contracts and deposits that were outstanding at the time of the failure. Auditors should consider the following issues:

- Cash on deposit with Lehman Brothers, certain receivables under derivatives contracts, and certain open securities purchases may not have been recoverable on a timely basis and may now represent claims on the bankruptcy estate of Lehman Brothers. The exact status of those claims may depend on the precise legal entity under which the balance was held or contract was placed. Careful analysis, including, as necessary, consultation with counsel, is required to assess the legal rights of the creditors of Lehman Brothers under the contracts and to estimate their fair value, which often may not be equivalent to their stated value.

- Preliminary contacts suggest that Lehman Brothers is unlikely to respond to requests to confirm, for audit purposes, balances and contracts outstanding and open (and thus subject to bankruptcy claims) as of the date of its bankruptcy. Because these claims in many cases may not be settled prior to an opinion date, auditors may be required to identify and perform alternative procedures to satisfy the existence assertion with respect to Lehman Brothers-related positions.

- As a result of the failure of Lehman Brothers, it was unable to return many securities it had borrowed under securities lending agreements. Accordingly, lenders took control of cash or marketable securities pledged as collateral and purchased identical securities in the market. Generally, for financial reporting purposes, securities lending transactions and actions taken upon default are addressed in FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125. For federal income tax purposes, the IRS issued Revenue Procedure 2008-63 on September 26, 2008, that provided for nonrecognition of gain or loss in a transaction in which a borrower defaults as a result of its bankruptcy and, as soon as commercially practicable but in no event more than 30 days from the default date, the lender applies collateral (or cash generated from sale of the collateral) to the purchase of identical securities.

Auditing Fair Value Measurements

It is management’s responsibility to determine and disclose an entity’s fair value measurements. When auditing these fair values to ensure conformity with GAAP, auditors should consult AU section 328, Auditing Fair Value Measurements and Disclosures (AICPA, Professional Standards, vol. 1), which establishes standards and provides guidance for auditors. Specific types of fair value measurements are not covered by AU section 328. For example, when auditing the fair value of derivatives and securities, refer to AU section 332, as previously mentioned.

The strongest audit evidence to support a fair value is an observable market price in an active market. If that is not available, a valuation method should incorporate common market assumptions. If common market assumptions are not available or require significant adjustments, the entity may use its own assumptions. The auditor should obtain an understanding of the entity’s process for determining fair values as well as whether the fair value measurements and disclosures are in accordance with GAAP. During this testing, the auditor also may identify possible indicators of impairment. According to paragraph .23 of AU
section 328, “substantive tests of the fair value measurements may involve (a) testing management’s significant assumptions, the valuation model, and the underlying data, (b) developing independent fair value estimates for corroborative purposes, or (c) reviewing subsequent events and transactions.”

.102 According to paragraph .48 of AU section 328, the auditor ordinarily should add language to the letter of representations from management regarding the reasonableness of significant underlying assumptions. When significant assumptions are used or they are highly subjective and the items being measured at fair value are material, the auditor should consider discussing these items with those charged with governance of the entity.

**Fair Values of Securities**

.103 The guidance in AU section 332 relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, some items are of interest for the auditor. As previously noted, quoted market prices in active markets are the best available audit evidence to support a fair value. However, when they are unavailable and the valuations of securities are obtained from a broker-dealer or another third party source based on valuation models, the auditor should understand the underlying valuation method used (such as a cash flow projection). The auditor also may determine that it is necessary to obtain quotes from more than one pricing source based on circumstances, such as an existing relationship between the entity and the valuing entity, which could inhibit objective pricing or underlying valuation assumptions that are highly subjective. In the context of FASB Statement No. 157, quoted prices for identical instruments in active markets are considered level 1 inputs.

.104 When an entity performs its own valuation, testing procedures to be undertaken by the auditor include assessing the reasonableness and appropriateness of the model, estimating the value using his or her own model, and comparing the fair value with subsequent or recent transactions. Whether the inputs to the entities’ valuation model are observable determines their characterization as level 2 or level 3 inputs, respectively, within FASB Statement No. 157. When an auditor encounters complex or subjective matters that may require special skill or knowledge, the auditor may require using the work of a specialist, in accordance with AU section 336, Auditing Accounting Estimates (AICPA, Professional Standards, vol. 1). Additionally, when the underlying collateral of a security significantly contributes to its fair value and collectability of the security, evidence of the collateral also may be examined for existence, fair value, transferability, and the investor’s right to the collateral.

**PCAOB Staff Audit Practice Alert No. 2**

.105 In December 2007, the Public Company Accounting Oversight Board (PCAOB) issued Staff Audit Practice Alert No. 2, Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 400 par. .02), that is intended to remind auditors of their responsibilities under existing PCAOB standards and is divided into four sections (auditing fair value measurements, classification within the FASB Statement No. 157 valuation hierarchy, using the work of specialists, and use of a pricing service), which are summarized as follows.

**Fair Value Measurements**

.106 The PCAOB Staff Audit Practice Alert No. 2 notes that the auditor should obtain an understanding of the company’s process for determining fair value measurements and disclosures, including relevant controls, and should, among other things,

- evaluate whether management’s assumptions are reasonable and either reflect, or are not inconsistent with, market information.
- consider the extent to which management’s reliance on historical financial information in the development of an assumption is justified.
• evaluate whether the company’s method for determining fair value measurements is applied consistently and if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the company.

.107 The auditor also should consider the increased risk of management bias and material misstatement if valuation inputs are not observable.

**Classification Within the FASB Statement No. 157 Valuation Hierarchy**

.108 The PCAOB Staff Audit Practice Alert No. 2 notes that “because there are different consequences associated with each of the three levels of the hierarchy, the auditor should be alert for circumstances in which the company may have an incentive to inappropriately classify fair value measurements within the hierarchy.” As examples of incentives, it notes that lower-level classifications permit greater use of management judgment in valuation and that level 3 measurements require more extensive disclosures than other levels.

**Use of Specialists**

.109 The PCAOB Staff Audit Practice Alert No. 2 also reminds auditors that they should evaluate whether they have the necessary skill and knowledge to perform audit procedures related to fair value measurement, considering such factors as significant use of unobservable inputs, complexity of valuation techniques, and materiality of the measurements. It also reminds auditors of their responsibilities when using the work of a specialist, whether engaged by the issuer or auditor.

**Use of a Pricing Service**

.110 The PCAOB Staff Audit Practice Alert No. 2 states that, if a company uses a pricing service, the auditor should determine the nature of the information the pricing service provides (for example, quoted prices from an active market, observable inputs, or model-based measurements) and adjust audit procedures accordingly. If measurements are based on a model, the auditor should obtain an understanding of the model and evaluate the reasonableness of assumptions. It also reminds the auditor to consider whether the prices provided by the service meet the “principal market” or “most advantageous market” criteria of FASB Statement No. 157.

.111 The full text of the PCAOB Staff Audit Practice Alert No. 2 is available at www.pcaob.org/Standards/Staff_Questions_and_Answers/2007/12-10_APAPA_2.pdf.

**Using the Work of a Specialist**

.112 As the PCAOB Staff Audit Practice Alert No. 2 points out, it is important to consider if you require the work of a specialist. It may be necessary to use a specialist to assist in auditing complex or subjective matters during the audit. Examples of matters for which an auditor may engage a specialist are valuation issues; reasonableness determination of amounts derived from specialized techniques or models; or implementation of technical requirements, regulations, or legal documents. AU section 336 provides guidance to auditors who are using specialists. The guidance in AU section 336 is applicable when the specialist is hired by management or if the auditor engages the specialist. However, if a specialist employed by the auditor’s firm participates in the audit, AU section 311, Planning and Supervision (AICPA, Professional Standards, vol. 1), is applicable rather than AU section 336.

.113 When using the work of a specialist, the auditor should evaluate the specialist’s professional qualifications, obtain an understanding of the nature of the work performed or to be performed, and evaluate the relationship of the specialist to the client in terms of objectivity. Although the appropriateness and reasonableness of the methods and assumptions employed by the specialist are his or her responsibility, the auditor should obtain an understanding of these qualities, test the underlying data provided to the
specialist, and evaluate the specialist’s findings in the context of the audit and related assertions in the financial statements.

**Liquidity Considerations**

.114 The AICPA staff has issued Technical Questions and Answers (TIS) section 1100.15, “Liquidity Restrictions” (AICPA, Technical Practice Aids), addressing the potential accounting and auditing implications when a fund or its trustee imposes restrictions on a nongovernmental entity’s ability to withdraw its balance in a money market fund or other short term investment vehicle. The question and answer covers balance sheet classification, disclosures, debt covenants, subsequent events, and going concern considerations, among other things, and can be found at www.aicpa.org/download/acctstd/TIS1100_15.pdf.

**Consideration of an Entity’s Ability to Continue as a Going Concern**

.115 The consideration of an entity’s ability to continue as a going concern is required in every audit performed under generally accepted auditing standards and is an especially important consideration in the current state of the residential market and the overall economy. It is important to note the time frame for this consideration is one year beyond the date of the financial statements. If the auditor believes there is a substantial doubt about the entity’s ability to continue as a going concern, the next steps are to obtain management’s plans to mitigate the effect of such conditions and then assess the likelihood these plans can be effectively implemented.

.116 If an auditor determines there is a substantial doubt about an entity’s ability to continue as a going concern, the auditor should communicate with those charged with governance of the entity, in accordance with AU section 341. AU section 341 provides guidance to an auditor with respect to evaluating whether there is substantial doubt about an entity’s ability to continue as a going concern and what the auditor should do when a going concern exists.

**Consideration of Fraud**

.117 Auditors should consider the pressures financial institutions are facing when planning and performing the audit engagement. Auditors have a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Paragraph .32 of AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), explains that “[w]hen obtaining information about the entity and its environment, the auditor should consider whether the information indicates that one or more fraud risk factors are present. The auditor should use professional judgment in determining whether a risk factor is present and should be considered in identifying and assessing the risks of material misstatement due to fraud.” Paragraph .33 of AU section 316 lists “three conditions generally present when fraud exists: incentive [or] pressure to perpetrate fraud, an opportunity to carry out the fraud, and attitude [or] rationalization to justify the fraudulent action.”

.118 A recent fraud discussed in the news, which appears to have contained all 3 conditions for fraud to occur, has been that of Bernard L. Madoff Investment Securities. At the time of this writing, the owner of the investment firm, Bernard Madoff, has been charged with paying off earlier investors with money from new investors over an extended period of time. This is reportedly a classic example of a Ponzi scheme, which could no longer be sustained as markets began declining and many investors requested redemptions of their capital. The losses from this fraud are estimated to be approximately $50 billion (including apparently fictitious profits reported to investors). Although the details of this fraud are just beginning to be investigated, the reported circumstances are a clear reminder to auditors to maintain professional skepticism and be alert to potential fraud risk factors.

**Auditing Alternative Investments**

.119 The AICPA’s nonauthoritative practice aid Alternative Investments—Audit Considerations focuses on the existence and valuation assertions associated with alternative investments, but also discusses general
considerations pertaining to auditing alternative investments, management representations, disclosure of certain significant risks and uncertainties, and reporting. As defined in the foreword of the practice aid, alternative investments are “investments for which a readily determinable fair value does not exist ... [including] private investment funds meeting the definition of an investment company ... such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as bank common [or] collective trust funds.” The full text of this practice aid can be found on the AICPA’s Web site at www.aicpa.org/download/members/div/auditstd/Alternative_Investments_Practice_Aid.pdf.

.120 The practice aid suggests that when the auditor determines the nature and extent of audit procedures, he or she should include verifying the existence of alternative investments. Confirming investments in aggregate does not constitute adequate audit evidence with respect to the existence assertion. Confirmation of existence of the holdings of the alternative investments on a security-by-security basis may constitute adequate audit evidence. Even if the fund manager confirms all requested information, the auditor may, based on his or her assessment of the risks of material misstatement, perform additional procedures, such as the following:

- Observing management site visits or telephone calls to investee funds (or reviewing documentation of such calls or visits)
- Reviewing executed partnership, trust, limited liability corporation, or similar agreements
- Inspecting other documentation supporting the investor’s interest in the fund (for example, correspondence from the fund or trustee acknowledging transactions with the fund)
- Reviewing periodic statements from the fund reflecting investment activity and comparing activity with amounts reported by the investor
- Vouching relevant cash receipts and disbursements

.121 Using one or more of the preceding approaches or another audit procedure in order to gather sufficient appropriate audit evidence with respect to the existence assertion requires considerable auditor judgment.

Auditing Considerations When Auditing Master-Feeder Funds

.122 Chapter 5 paragraphs .55–.87 of the 2008 guide describe several items that an auditor should consider when auditing feeder funds. The guide states master-feeder structures are capitalized by transferring the investments and related assets and liabilities of an existing fund to a newly organized master fund. In exchange for the assets transferred, the original fund becomes a feeder fund and receives a proportional ownership interest in the master fund. Chapter 5 paragraph .58 of the 2008 guide states that an auditor should consider the following when conducting an audit of master-feeder funds:

- “Fees and expenses incurred by the master fund or feeder funds are in accordance with contractual agreements as disclosed in the registration statement. Advisory and custodian fees are normally incurred only at the master fund; fees and expenses relating to distribution and shareholder servicing are normally incurred at the feeder level.
- Controls and procedures are adequate to ensure that investment valuation and related income components are allocated properly to feeder funds.
- Systems and controls are adequate to record accurately and timely the daily contributions and withdrawals between the feeder funds and the master fund. This is important to determine properly each feeder fund’s proportionate ownership interest for purposes of computing allocations. All [investor] purchases and redemptions are recorded at the feeder level. Assuming that cash is transferred on the same day, after the total daily net sales or redemptions are known for each feeder, contributions and withdrawals in the master fund are recorded to reflect changes in the feeders’ ownership interests (that is, a net redemption at the feeder level will result in a withdrawal from the master fund). All such transactions at the feeder level affect the investment in the master fund.
At the master fund level, the cash movements flow through the partnership equity or net assets account.

- Satisfaction has been obtained as to the accuracy of master fund tax adjustments allocated to the feeder funds.”

.123 It is important for auditors to note, as stated in chapter 5 paragraph .59 of the 2008 guide, that each feeder fund could have a different auditor who may also be different from the master-feeder fund auditor. It is also possible that the master-feeder fund and the feeder funds could have different year-ends. The following list highlights certain issues that may be of use to auditors of master-feeder funds:

- According to chapter 5 paragraph .60, each feeder fund auditor should discuss, with the master-feeder fund’s independent auditor, the most recent audit of the master-feeder fund.

- Chapter 5 paragraph .72 states that through discussions with feeder and master-feeder fund management and review of accounting records, the auditor should consider whether significant transactions of the master-feeder fund have been accounted for properly in the fund’s financial statements.

- The auditor also should consider requesting the master-feeder fund auditor to review or directly reviewing, the analysis and documentation with respect to the master-feeder fund’s investment restrictions compliance, as described in chapter 5 paragraph .74 of the 2008 guide.

.124 Chapter 5 paragraph .61 of the 2008 guide also states auditors “should inquire of feeder fund and master fund management as to any changes in fee structures, affiliated transactions, significant contingencies, results of regulatory reviews, or proposed transactions since the previous feeder fund and master fund audits.”

Illustrative Report on Internal Control Required by the SEC Under Form N-SAR

.125 In December 2007, the AICPA Investment Companies Expert Panel issued a revised version of the report on internal control issued in conjunction with an audit of financial statements of a registered investment company and filed on Form N-SAR, as required by the SEC. The revised version incorporates changes to the definitions of material weakness and deficiency, as described in PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”). The revised illustrative report is featured in chapter 11 of the 2008 guide. It also is available at www.aicpa.org/download/members/Div/acctstd/ N-SAR_AS_5_revision_Dec_2007.pdf.

Summary of Recent Auditing and Attestation Pronouncements and Related Guidance

.126 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. This alert is intended to be used in conjunction with the Comprehensive Audit Risk Alert—2008 (product no. 022339kk); therefore, only industry specific pronouncements and related guidance or those of specific significance to the industry are summarized herein. For information on auditing and attestation standards issued subsequent to the writing of this alert, please refer to the AICPA Accounting and Auditing Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing. You also may look for announcements of newly issued standards in the CPA Letter, Journal of Accountancy, and in the quarterly electronic newsletter In Our Opinion, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+ Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

.127 The PCAOB establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You also may review Audit Risk Alert SEC AAM §8100.123 Copyright © 2009, American Institute of Certified Public Accountants, Inc.
and PCAOB Developments—2008 (product no. 022499kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by visiting www.cpa2biz.com.

<table>
<thead>
<tr>
<th>Recent Auditing and Attestation Pronouncements and Related Guidance</th>
</tr>
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<tbody>
<tr>
<td><strong>Statement on Auditing Standards (SAS)</strong></td>
</tr>
<tr>
<td>No. 115, Communicating Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, vol. 1, AU sec. 325)</td>
</tr>
<tr>
<td>Issue Date: October 2008</td>
</tr>
<tr>
<td>(Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])</td>
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<tr>
<th><strong>SAS No. 114, The Auditor’s Communication With Those Charged With Governance</strong></th>
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<tr>
<td>(AICPA, Professional Standards, vol. 1, AU sec. 380)</td>
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<tr>
<td>Issue Date: December 2006</td>
</tr>
<tr>
<td>(Applicable to audits conducted in accordance with GAAS)</td>
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<tr>
<th><strong>SAS No. 113, Omnibus Statement on Auditing Standards—2006</strong></th>
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<td>(AICPA, Professional Standards, vol. 1)</td>
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<tr>
<td>Issue Date: November 2006</td>
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<td>(Applicable to audits conducted in accordance with GAAS)</td>
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### Recent Auditing and Attestation Pronouncements and Related Guidance

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<th>Pronouncement</th>
<th>Description</th>
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<tr>
<td><strong>SAS Nos. 104–111</strong>, the risk assessment standards</td>
<td>The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits; focusing on identifying and assessing the risks of material misstatements; further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels; and improving the linkage between the risks, controls, audit procedures, and conclusions. These eight SASs became effective for audits of financial statements for periods beginning on or after December 15, 2006.</td>
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<tr>
<td>Issue Date: March 2006</td>
<td><em>(Applicable to audits conducted in accordance with GAAS)</em></td>
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<td><strong>Statement on Standards for Attestation Engagements (SSAE) No. 15</strong>, <em>An Examination of an Entity’s Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements</em> ((AICPA, Professional Standards, vol. 1, AT sec. 501)</td>
<td>This statement establishes requirements and provides guidance that applies when a practitioner is engaged to perform an examination of the design and operating effectiveness of an entity’s internal control over financial reporting (examination of internal control) that is integrated with an audit of financial statements (integrated audit). This SSAE is effective for integrated audits for periods ending on or after December 15, 2008. Earlier implementation is permitted.</td>
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<tr>
<td>Issue Date: October 2008</td>
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<tr>
<td><strong>SSAE No. 14</strong>, SSAE Hierarchy (AICPA, Professional Standards, vol. 1, AT sec. 50)</td>
<td>This standard identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in AT section 20, <em>Defining Professional Requirements in Statements on Standards for Attestation Engagements</em> (AICPA, Professional Standards, vol. 1). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.</td>
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<td>Issue Date: November 2006</td>
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<tr>
<td>Issue Date: March 2002 Revised Date: May 2008</td>
<td><em>(Interpretive publication)</em></td>
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<tr>
<td><strong>Interpretation No. 19</strong>, “Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board,” of AU section 508 (AICPA, Professional Standards, vol. 1, AU sec. 9508 par. .93–.97)</td>
<td>This interpretation of AU section 508 addresses the application of AU section 508 in reporting on financial statements prepared in conformity with IFRS.</td>
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<tr>
<td>Issue Date: May 2008</td>
<td><em>(Interpretive publication)</em></td>
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Recent Auditing and Attestation Pronouncements and Related Guidance

| Interpretation No. 2, “Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board,” of AU section 534, Reporting on Financial Statements Prepared for Use in Other Countries (AICPA, Professional Standards, vol. 1, AU sec. 9534 par. .05–.08) | This interpretation of AU section 534 addresses the application of AU section 534 in reporting on financial statements prepared in conformity with IFRS. Issue Date: May 2008 (Interpretive publication) |
| Interpretation No. 3, “Financial Statements Audited in Accordance With International Standards on Auditing,” of AU section 534 (AICPA, Professional Standards, vol. 1, AU sec. 9534 par. .09–.11) | This interpretation of AU section 534 addresses the application of AU section 534 in audits of financial statements prepared for use outside the United States. Issue Date: May 2008 (Interpretive publication) |
| Statement of Position (SOP) 07-2, Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisers, or Other Service Providers (AICPA, Technical Practice Aids, AUD sec. 14,430) | This statement addresses the application of SSAEs primarily to examination engagements in which a practitioner reports on the suitability of the design and operating effectiveness of a service provider’s controls in achieving specified compliance control objectives. Examples of the service providers addressed by this SOP are investment advisers, custodians, transfer agents, administrators, and principal underwriters who provide services to investment companies, investment advisers, or other service providers. Issue Date: October 2007 (Interpretive publication) |
| AICPA Technical Questions and Answers (TIS) section 1100.15, “Liquidity Restrictions” (AICPA, Technical Practice Aids) | This question and answer discusses auditing and accounting issues related to withdrawal restrictions placed on short term investments by a money market fund or its trustee. Issue Date: October 2008 (Nonauthoritative) |

(continued)
### Recent Auditing and Attestation Pronouncements and Related Guidance

| TIS sections 8200.05–.16 (AICPA, *Technical Practice Aids*) | These questions and answers in TIS section 8200, *Internal Control* (AICPA, *Technical Practice Aids*), were developed in response to common questions received from members regarding the implementation of SAS Nos. 104–111. Some of the topics are as follows:
| Issue Date: April and May 2008 (Nonauthoritative) | • Consideration of internal controls that are less formal or not documented by the client
| | • Whether the auditor may suggest improvements to a client’s internal control
| | • Assessing inherent risk in relation to the consideration of control risk
| | • The frequency of walkthroughs that are used as the basis for the auditor’s understanding of internal control
| | • Considerations in obtaining an understanding of, evaluating, and documenting controls that the auditor believes are nonexistent or ineffective
| | • Assessing control risk at the maximum level
| | • Considerations for developing a substantive audit strategy
|
| TIS section 9120.08, “Part of an Audit Performed in Accordance With International Standards on Auditing” (AICPA, *Technical Practice Aids*) | This question and answer discusses the implications to the principal auditor’s report when part of an audit is conducted by other independent auditors in accordance with International Standards on Auditing or another country’s auditing standards.
| Issue Date: April 2008 (Nonauthoritative) | |
| TIS section 9100.06, “The Effect of Obtaining the Management Representation Letter on Dating the Auditor’s Report” (AICPA, *Technical Practice Aids*) | This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor’s report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor’s report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that it will sign the representation letter, without exception, on or before the date of the representations.
| Issue Date: May 2007 (Nonauthoritative) | |
| TIS section 8350.01, “Current Year Audit Documentation Contained in the Permanent File” (AICPA, *Technical Practice Aids*) | This question and answer discusses whether the provisions of AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), related to documentation completion and retention apply to current year audit documentation maintained in the permanent file. The question and answer indicates that AU section 339 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year’s audit report.
| Issue Date: May 2007 (Nonauthoritative) | |
### Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Pronouncement</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AICPA PITF Practice Alert (PA) 03-1, <em>Audit Confirmations</em> (AICPA, <em>Technical Practice Aids</em>, PA sec. 16,240)</td>
<td>This practice alert is a response to practitioners’ current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations, among other topics.</td>
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<td>AICPA PITF PA 07-1, <em>Dating of the Auditor’s Report and Related Practical Guidance</em> (AICPA, <em>Technical Practice Aids</em>, PA sec. 16,290)</td>
<td>This practice alert provides guidance regarding application of certain provisions of AU section 339, primarily related to dating the auditor’s report.</td>
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<tr>
<td>Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 6, <em>Evaluating Consistency of Financial Statements</em> (AICPA, <em>PCAOB Standards and Related Rules</em>, Rules of the Board, “Standards”)</td>
<td>This standard and its related amendments update the auditor’s responsibilities to evaluate and report on the consistency of a company’s financial statements and align the auditor’s responsibilities with Financial Accounting Standards Board (FASB) Statement No. 154, <em>Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3</em>. This standard also improves the auditor reporting requirements by clarifying that the auditor’s report should indicate whether an adjustment to previously issued financial statements results from a change in accounting principles or the correction of a misstatement.</td>
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<tr>
<td>PCAOB Auditing Standard No. 5, <em>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</em> (AICPA, <em>PCAOB Standards and Related Rules</em>, Rules of the Board, “Standards”)</td>
<td>This standard replaces the PCAOB’s previous internal control standard, Auditing Standard No. 2, <em>An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements</em>. This principles-based auditing standard is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company’s financial statements, and, at the same time, eliminate procedures that are unnecessary.</td>
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Recent Auditing and Attestation Pronouncements and Related Guidance

PCAOB Rule 3526, Communication with Audit Committees Concerning Independence (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”)  
Issue Date: August 2008  
(Applicable to audits conducted in accordance with PCAOB standards)

Rule 3526 requires the registered public accounting firm to
• describe in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence.
• discuss with the audit committee of the issuer the potential effects of any relationships that could affect independence if they are appointed as the issuer’s auditor.
• document the substance of these discussions. These discussions should occur at least annually.

The board also adjusted the implementation schedule for PCAOB Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”), as it applies to tax services. The board agreed not to apply Rule 3523 to tax services provided on or before December 31, 2008, when those services are provided during the audit period and are completed before the professional engagement period begins. The amendments to Rule 3523 became effective August 28, 2008. The remaining provisions of Rule 3526 became effective on September 30, 2008.

PCAOB Rule 3525, Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”)  
Issue Date: July 2007  
(Applicable to audits conducted in accordance with PCAOB standards)

This rule requires a registered public accounting firm that seeks preapproval of an issuer audit client’s audit committee to perform internal control-related nonaudit services that are not otherwise prohibited by the act or the rules of the Securities and Exchange Commission (SEC) or the PCAOB to describe in writing, to the audit committee, the scope of the proposed service; discuss with the audit committee the potential effects of the proposed service on the firm’s independence; and document the substance of the firm’s discussion with the audit committee. These requirements parallel the auditor’s responsibility in seeking audit committee preapproval to perform tax services for an audit client under PCAOB Rule 3524, Audit Committee Pre-approval of Certain Tax Services (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”). This rule is effective for audits of fiscal years ending on or after November 15, 2007.

PCAOB Conforming Amendments to the Interim Auditing Standards (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)  
Issue Date: September 2008  
(Applicable to audits conducted in accordance with PCAOB standards)

In conjunction with the PCAOB’s adoption of Auditing Standard No. 6, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in appendix 2 of PCAOB Release No. 2008-001 at www.pcaob.org/Rules/Docket_023/PCAOB_Release_No._2008-001_-_Evaluating_Consistency.pdf.  
These amendments became effective November 15, 2008.
<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
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<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
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<td>In conjunction with the PCAOB’s adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in appendix 3 of PCAOB Release No. 2007-005A at <a href="http://www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf">www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf</a>. These amendments are effective for audits of fiscal years ending on or after November 15, 2007, the same effective date of Auditing Standard No. 5.</td>
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<tr>
<td>Issue Date: January 2007</td>
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<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
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<td>This release focuses on aspects of the PCAOB’s interim auditing standards that address the auditor’s responsibility with respect to fraud, specifically AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, PCAOB Standards and Related Rules, PCAOB Standards, As Amended). This release does not change or propose to change any existing standard nor is the PCAOB providing any new interpretation of existing standards.</td>
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<tr>
<td>PCAOB Staff Questions and Answers, Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 100 par. .05)</td>
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<tr>
<td>Issue Date: April 2007</td>
</tr>
<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
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<td>Topics covered include the following:</td>
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<td>• The application of PCAOB Rule 3522(a), Tax Transactions (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”), when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm</td>
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<td>• Whether a public accounting firm can advise an audit client on the tax consequences of structuring a particular transaction</td>
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<td>• Whether a registered public accounting firm’s independence is affected by the IRS’s subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in PCAOB Rule 3522(b)</td>
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<td>• Clarification that the auditor must evaluate whether a person is in a financial reporting oversight role at affiliates and not just the audit client itself</td>
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<tr>
<td>• Clarification of the term other change in employment event as it relates to PCAOB Rule 3522(c)</td>
</tr>
<tr>
<td>PCAOB Staff Audit Practice Alert No. 3, Audit Considerations in the Current Economic Environment (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 400 par. .03)</td>
</tr>
<tr>
<td>Issue Date: December 2008</td>
</tr>
<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
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<td>This practice alert is designed to assist auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis. The practice alert addresses six main areas: overall audit considerations, auditing fair value measurements, auditing accounting estimates, auditing the adequacy of disclosures, the auditor’s consideration of a company’s ability to continue as a going concern, and additional audit considerations for selected financial reporting areas. This practice alert can be found at <a href="http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/2008/12-05_APA_3.pdf">www.pcaobus.org/Standards/Staff_Questions_and_Answers/2008/12-05_APA_3.pdf</a></td>
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Recent Auditing and Attestation Pronouncements and Related Guidance

PCAOB Staff Audit Practice Alert No. 2, Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 400 par. .02)

Issue Date: December 2007
(Applicable to audits conducted in accordance with PCAOB standards)

This practice alert highlights certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of generally accepted accounting principles that are particularly relevant to the current economic environment.

Accounting Issues and Developments

Investment Companies TPAs

.128 The AICPA has issued four TIS sections that cover a wide range of investment company related topics. The questions and answers can be found in TIS sections 6910.25–.28 (AICPA, Technical Practice Aids). The following are brief summaries of each TIS section:


- TIS section 6910.26, “Additional Guidance on Determinants of Net Versus Gross Presentation of Security Purchases and Sales/Maturities in the Statement of Cash Flows of a Nonregistered Investment Company,” explains the circumstances, if any, under which an entity may report purchases and sales or maturities in the operating section of the statement of cash flows of a nonregistered investment company on a net, rather than gross, basis.

- TIS section 6910.27, “Treatment of Deferred Fees,” provides guidance on appropriate financial reporting by an investment company if an investment advisor elects to defer payment of its management fee, incentive fee, or both based on the governing documents for offshore funds. TIS section 6910.27 also provides illustrative examples of deferred incentive fee presentation and related disclosures in the financial statements.

- TIS section 6910.28, “Reporting Financial Highlights, Net Asset Value (NAV) Per Share, Shares Outstanding, and Share Transactions When Investors in Unitized Nonregistered Funds Are Issued Individual Classes or Series of Shares,” explains how financial highlights (per share data, ratios, and total return) may be presented in financial statements when unitized funds issue separate series of shares to each individual investor in the fund. The question and answer also covers how each series of shares outstanding at period end and share transactions during the period may be disclosed in the financial statements.

.129 For the entire text of these TPAs visit www.aicpa.org/download/acctstd/TIS6910_25_28.pdf.
Fair Value Measurements

FASB Statement No. 157

.130 In September 2006, FASB issued Statement No. 157 to provide enhanced guidance for using fair value to measure assets and liabilities. This standard defines fair value and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances.

.131 Prior to this statement, the definitions of fair value differed and guidance for applying those definitions was dispersed among many accounting pronouncements. Differences in the existing guidance created inconsistencies that added to the complexity in applying GAAP. FASB Statement No. 157 provides increased consistency and comparability in fair value measurements. Expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the use of fair value in the financial statements, the inputs used to develop the measurements, and the effect of the measurements on earnings (or changes in net assets) for the period.

.132 FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. In February 2008, FASB also issued FSP FAS 157-2, Effective Date of FASB Statement No. 157, which was effective upon issuance. The FSP delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years, for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow FASB and its constituents the time to consider the various implementation issues associated with FASB Statement No. 157.

.133 In October 2008, FASB issued FSP FAS 157-3, which clarifies FASB Statement No. 157’s application in an inactive market and also amends the standard to include an illustrative example.

Measurements of Fair Value in Illiquid Markets

.134 Given the state of the market, confusion exists around the use of “market” quotes and whether current market prices represent fair value in accordance with FASB Statement No. 157 or are in actuality distressed sales. On September 30, 2008, while FASB was going through its due process to issue interpretative guidance, the SEC issued a press release, SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting (SEC and FASB press release) in an effort to assist preparers and auditors by providing immediate clarification. Ten days later, FASB issued FSP FAS 157-3. FSP FAS 157-3 also amends FASB Statement No. 157 to include an illustrative example, which is intended to provide a framework for assessing the appropriate fair value of a financial asset in an inactive market. FSP FAS 157-3 noted the consistency between the guidance provided in it and the guidance provided in the SEC and FASB press release.

.135 FSP FAS 157-3 noted the following:

Broker (or pricing service) quotes may be an appropriate input when measuring fair value, but they are not necessarily determinative if an active market does not exist for the financial asset. ... In weighing a broker quote as an input to a fair value measurement, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence.

.136 Two other factors to consider when considering the reliability of a quote are whether it can be determined that market participants currently are transacting at that price and the appropriateness of the valuation technique employed by the pricing service to arrive at the quoted price.
As discussed in paragraph 7 of FASB Statement No. 157, “[a]n orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).” Low transaction volume involving such assets does not necessarily translate into forced sales, nor does it necessarily mean the market is inactive. The market would still be considered active as long as the frequency and volume of transactions are sufficient to provide reliable pricing information. Additionally, the size of an entity’s position should not be a factor in this determination. To deem a transaction forced or disorderly, persuasive evidence and judgment are required.

If transaction volume is too low to provide accurate pricing information and therefore is not a level 1 input, those observable transactions are to be considered level 2 inputs or even level 3 inputs if they are significantly adjusted. In October 2007, the Center for Audit Quality (CAQ), which is affiliated with the AICPA, issued a white paper on the topic and noted that some characteristics of an inactive market are “few transactions for the asset, the prices are not current, price quotations vary substantially, or in which little information is released publicly.” In describing an inactive market as well, the SEC and FASB press release noted, “A significant increase in the spread between the amount sellers are ‘asking’ and the price that buyers are ‘bidding,’ or the presence of a relatively small number of ‘bidding’ parties, are indicators that should be considered in determining whether a market is inactive.”

The lack of an active market and the information obtained from it require further analysis. According to FSP FAS 157-3, “[I]n cases where the volume and level of trading activity in the asset have declined significantly, the available prices vary significantly over time or among market participants, or the prices are not current, the observable inputs might not be relevant and could require significant adjustment.” Further, the SEC and FASB press release noted that “in some cases using unobservable inputs (level 3) might be more appropriate than using observable inputs (level 2); for example, when significant adjustments are required to observable inputs it may be appropriate to utilize an estimate based primarily on unobservable inputs.” When significant adjustments are made to an observable input (level 2), it becomes a level 3 fair value measurement. The level of activity in the market in which transactions occur (that is, whether the market is active or inactive) is an indicator of the extent to which the entity will have relevant observable market data that will not require a significant adjustment in its determination of fair value.

Paragraph C85 of FASB Statement No. 157 states that “the reporting entity may use its own data to develop unobservable inputs, provided that there is no information reasonably available without undue cost and effort that indicates that market participants would use different assumptions in pricing the asset or liability.” A reporting entity is prohibited from ignoring observable transactions or assumptions that are reasonably available without undue cost and effort.

FSP FAS 157-3 concludes that “the use of a reporting entity’s own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available.” Similarly, the SEC and FASB press release noted, “In some cases, multiple inputs from different sources may collectively provide the best evidence of fair value. In these cases expected cash flows would be considered alongside other relevant information. The weighting of the inputs in the fair value estimate will depend on the extent to which they provide information about the value of an asset or liability and are relevant in developing a reasonable estimate.”

Readers are encouraged to review the full text of FSP FAS 157-3 and the amended standard (inclusive of its recently added illustrative example) on FASB’s Web site at www.fasb.org. FSP FAS 157-3 was effective upon issuance, including any prior periods for which financial statements have not been issued. Any revisions from changes in valuation techniques or their application shall be accounted for as a change in accounting estimate in accordance with FASB Statement No. 154, Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3; however, the disclosure provisions of FASB Statement No. 154 for such revisions are not required.
Valuation Resource Group

.143 FASB has established the Valuation Resource Group (VRG), which provides FASB staff with information on the existing implementation issues surrounding fair value measurements used for financial statement reporting purposes and the alternative viewpoints associated with those implementation issues. Any authoritative decisions are subject to FASB’s normal open due process. A summary of the VRG’s discussions is available on FASB’s Web site at http://72.3.243.42/project/valuation_resource_group.shtml.

.144 Although the VRG deliberations are not authoritative, one issue contained in this summary is of particular interest to investment companies and other enterprises that invest in investment companies, especially investment companies that do not have daily liquidity. In that issue, titled Issue 2007-10, “Use of Net Asset Value in Fund of Fund Investments,” the FASB staff observed that it would be inconsistent with FASB Statement No. 157 to presume that NAV automatically equals fair value. Further, the staff believes that FASB Statement No. 157 provides reasonable guidance on how to adjust NAV to fair value. Accordingly, the staff is of the view that this specific issue does not warrant any FASB action or further action from the staff at this time.

.145 In addition to the preceding issue, the AICPA Investment Companies Expert Panel also has discussed a number of FASB Statement No. 157 implementation issues, including the following:

- Valuation of in-kind distributions
- Fair value used for transfers in and out of level 3
- Application of FASB Statement No. 157 to newly launched funds
- Evaluation of significant events that occurred after hours but before the end of the fiscal year
- Transaction costs
- Use of broker quotes and pricing services

.146 Refer to the meeting highlights of the AICPA Investment Companies Expert Panel for further detail on these issues at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_investco_highlights.htm.

Valuation Considerations for Interests in Alternative Investments

.147 As discussed in a meeting of the FASB’s VRG, NAV of an investment in an alternative investment fund may not represent fair value under FASB Statement No. 157. Given the state of the economy, many funds are imposing limitations on redemptions and some are even unwinding. As this occurs, the fair value measurements applied to these investments will fall under increased scrutiny and become even more important.

.148 In January 2009, the Accounting Standards Executive Committee (AcSEC) of the AICPA issued a draft issues paper, FASB Statement No. 157 Valuation Considerations for Interests in Alternative Investments. The draft issues paper discusses how to estimate the fair value of alternative investments (such as interests in hedge funds, private equity funds, or real estate funds) in accordance with the provisions of FASB Statement No. 157. The draft issues paper also discusses the role of NAV in estimating fair value.

.149 AcSEC and the Alternative Investments Task Force, which developed this draft issues paper, are looking for informal feedback. Comments should be received by February 27, 2009. For more information, visit www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/AcSEC-Issues+Draft+Issues+Paper+on+Valuation+of+Interests+in+Alternative+Investments.htm.
FASB Statement No. 159

.150 Subsequent to the issuance of FASB Statement No. 157, FASB issued Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115. This statement is expected to expand the use of fair value measurement, which is consistent with FASB’s long term measurement objectives for accounting for financial instruments. FASB Statement No. 159 allows entities to choose to measure many financial instruments and certain other items at fair value. The standard permits an entity to elect the fair value option on an instrument-by-instrument basis; once the election is made, it is irrevocable. This statement’s objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently, without having to apply complex hedge accounting provisions. In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons among entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement Nos. 107 and 157.

.151 FASB Statement No. 159 is effective as of the beginning of an entity’s first fiscal year that begins after November 15, 2007. FASB and the SEC expressed concern in the way some early adopters applied the transition provisions of the standard. The CAQ issued an alert on this development in April 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles based standard, such as this, is applied in a good faith manner consistent with those objectives and principles. Specifically, the alert warns auditors to “be alert for circumstances in which an entity proposes to adopt FAS 159 in a manner that is contrary to the principles and objectives outlined in the standard.” The alert can be accessed at www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf.

Disclosures About Derivative Instruments and Hedging Activities

.152 In March 2008, FASB issued FASB Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133. The standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity’s financial position, financial performance, and cash flows.

.153 The standard improves transparency about the location and amounts of derivative instruments in an entity’s financial statements; how derivative instruments and related hedged items are accounted for under FASB Statement No. 133; and how derivative instruments and related hedged items affect the entity’s financial position, financial performance, and cash flows.

.154 FASB Statement No. 161 achieves these improvements by requiring disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also provides more information about an entity’s liquidity by requiring disclosure of derivative features that are credit risk related. Finally, it requires cross referencing within footnotes to enable financial statement users to locate important information about derivative instruments.

.155 It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. FASB also has clarified, in FSP FAS 133-1 and FASB Interpretation (FIN) 45-4, Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161, the effectiveness provisions to include annual financial statements, including the final interim period of the year.

.156 In regards to registered investment companies, the staff of the SEC Division of Investment Management has stated informally at industry conferences that it would expect application of FASB Statement No. 161 to either annual or semiannual financial statements issued, which include a semiannual period (but not a quarterly period) beginning after November 15, 2008. Further, the staff indicated that it would expect the provisions of FASB Statement No. 161 to be applied to schedule of investments information.
appearing in Form N-Q for quarterly periods beginning after November 15, 2008, if inclusion of such disclosure would be material to a user’s understanding of the information otherwise required to be reported in the filing.

FSP FAS 140-3

.157 In February 2008, FASB issued FSP FAS 140-3, Accounting for Transfer of Financial Assets and Repurchase Financing Transactions, which was intended to address questions about the accounting for a repurchase agreement relating to a previously transferred financial asset. One question FSP FAS 140-3 specifically addresses is whether circumstances exist that would permit a transferor and transferee to evaluate the accounting for a transfer of a financial asset separately from a repurchase financing under FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125, when the counterparties to the two transactions are the same. FSP FAS 140-3 presumes that an initial transfer and repurchase financing are part of the same arrangement and provides certain criteria that, if met, allow the two transactions to be evaluated separately under FASB Statement No. 140. Among the criteria are the following:

- The two transactions have a valid and distinct business purpose for being entered into separately.
- The initial transfer and repurchase financing are not contractually contingent upon one another, and the pricing and performance of either transaction is not dependent on the terms and execution of the other.
- The repurchase financing provides the initial transferor with recourse to the initial transferee upon default, not solely to the market risk of the transferred asset.
- The financial asset subject to the transactions is readily obtainable in the marketplace, and the transactions are executed at market rates.
- The maturity of the repurchase financing must be before the maturity of the financial asset.

.158 FSP FAS 140-3 is effective for financial statements issued for fiscal years beginning after November 15, 2008, and interim periods within those years. Refer to the FASB Web site for the full text of FSP FAS 140-3.

Tax Exempt Debt

.159 In May 2008, the AICPA issued a nonauthoritative article, “Tax-Exempt Bonds—Accounting and Auditing Considerations in the Current Environment.” The focus of the article is on debt that is referred to as auction rate securities and variable rate demand obligations. The article provides issuers of tax-exempt debt and their auditors an overview of the accounting and auditing considerations that may be relevant in light of recent market events and entity transactions. Although the current environment presents accounting and auditing issues for investors in that tax-exempt debt, the article focuses on issues facing the issuers of that debt. The article can be accessed at www.aicpa.org/download/acctstd/ARS_article14.pdf.

Convergence With International Financial Reporting Standards

.160 Since the signing of the Norwalk Agreement by FASB and the IASB, the bodies have had a common goal—one set of accounting standards for international use. In this agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. In 2005 meetings, FASB and the IASB reaffirmed their commitment to the convergence of U.S. GAAP and IFRS. A common set of high quality, globally accepted standards remains the long term strategic priority of both FASB and the IASB.

.161 FASB and the IASB have undertaken several joint projects that are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and IFRS. These ongoing joint projects address the conceptual framework, business combinations, financial statement presentation, and revenue recognition. For more information on the status of this project, go to www.fasb.org and www.iasb.org.
SEC Eases Acceptance of IFRS Financial Statements

.162 On December 21, 2007, the SEC took a major step toward easing the acceptance of IFRS financial statements by adopting rules to accept from foreign private issuers financial statements prepared in accordance with IFRS as issued by the IASB without reconciliation to U.S. GAAP. This rule marks an important step in the process toward the development of a single set of high quality, globally accepted accounting standards. This rule became effective March 4, 2008. Readers can access this rule at www.sec.gov/rules/final/2007/33-8879.pdf.

.163 More than 100 countries now either require or allow the use of IFRS for the preparation of financial statements by listed companies, and additional countries are moving to do the same. This recent movement to IFRS outside the United States has resulted in an increase of filings with the SEC of foreign private issuers that represent in the footnotes to their financial statements that their financial statements comply with IFRS, as published by the IASB—from a relative few in 2005 to approximately 110 in 2006. The SEC expects this number will continue to increase in the future, particularly pursuant to Canada’s announced move to IFRS because approximately 500 foreign private issuers are currently from Canada.

.164 This movement to IFRS also has begun to affect U.S. issuers, in particular those with a significant global footprint. For instance, certain U.S. issuers may compete for capital globally in industry sectors in which a critical mass of non-U.S. companies report under IFRS. Also, U.S. issuers with subsidiaries located in jurisdictions that have moved to IFRS may prepare those subsidiaries’ financial statements in IFRS for purposes of local regulatory or statutory filings. Readers should remain alert to developments regarding convergence.

IFRS “Roadmap”

.165 On November 14, 2008, the SEC released for public comment, in the format of a proposed rule, a roadmap that could lead to the use of IFRS by U.S. issuers beginning in 2014. The SEC will make a decision in 2011 on whether adoption of IFRS is in the public interest and would benefit investors. The proposed multiyear plan sets out several milestones that, if achieved, could lead to the use of IFRS by U.S. issuers in their filings with the SEC.

.166 The top 20 companies in each industry, as determined by market capitalization, could elect to begin filing IFRS financial statements for fiscal periods ending after December 15, 2009. If, in 2011, the SEC adopts IFRS for all filers, the roadmap suggests mandatory filing for large accelerated filers beginning in 2014, accelerated filers in 2015, and nonaccelerated filers in 2016. The 90 day comment period ends on February 19, 2009.

.167 The proposed roadmap sets forth seven milestones that will influence the SEC’s decision to adopt IFRS for all filers. These milestones relate to improvements in accounting standards, the accountability and funding of the International Accounting Standards Committee Foundation, the improvement in the ability to use interactive data for IFRS reporting, education and training relating to IFRS, limited early use of IFRS in cases in which it would enhance comparability for U.S. investors, the anticipated timing of future rulemaking by the SEC, and the implementation of the mandatory use of IFRS by U.S. issuers.

.168 Additionally, the roadmap discusses two alternatives for U.S. issuers that elect to use IFRS to disclose U.S. GAAP information. Proposal A suggests that a U.S. issuer that elects to file IFRS financial statements would provide the reconciling information from U.S. GAAP to IFRS called for under IFRS 1, First-Time Adoption of International Financial Reporting Standards, in a footnote to its audited financial statements. This information would include the restatement of, and reconciliation from, prior year’s financial statements and the related disclosures.

.169 Proposal B suggests that U.S. issuers that elect to file IFRS financial statements would provide the reconciling information from U.S. GAAP to IFRS required under IFRS 1 and also would disclose on an annual basis certain unaudited supplemental U.S. GAAP financial information covering a three year period.
This unaudited supplemental financial information would be in the form of a reconciliation from IFRS to U.S. GAAP.

.170 The roadmap does not address how the SEC would mandate IFRS; however, it noted an option would be “for the FASB to continue to be the designated standard setter for purposes of establishing the financial reporting standards in issuer filings with the Commission. In this option our presumption would be that the FASB would incorporate all provisions under IFRS, and all future changes to IFRS, directly into GAAP as used in the United States. This type of approach has been adopted by a significant number of other jurisdictions when they adopted IFRS as the basis of financial reporting in their capital markets.”

.171 Readers of this alert should note that the proposed roadmap excludes from its scope issuers that are investment companies under the Investment Company Act of 1940 and specifically excludes investment companies from the proposed definition of the IFRS issuer.


AICPA Launches IFRS.com Web Site

.173 The AICPA is calling for an orderly transition and reasonable time frame of three to five years for the U.S. accounting profession to adopt IFRS. During a FASB forum on June 16, 2008, held to facilitate an open dialogue about whether and how to move the U.S. financial reporting system to IFRS and define the next steps in that process, it was noted that awareness of IFRS is growing, but most believe it will take three to five years to prepare.

.174 To assist in both awareness building and education, the AICPA launched a new Web site, www.i-frs.com, in May 2008. The site provides current information about developments in international convergence. The growing acceptance of IFRS as a basis for U.S. financial reporting represents a fundamental change for the U.S. accounting profession. Acceptance of a single set of high-quality accounting standards for worldwide use by public companies has been gaining momentum around the globe for the past few years.

.175 Developed by the AICPA, in partnership with its marketing and technology subsidiary, CPA2Biz, www.ifrs.com provides a comprehensive set of resources for accounting professionals, auditors, financial managers, audit committees, and other users of financial statements.

.176 The Web site features tools and resources to help CPAs get acquainted with IFRS, the surrounding issues, and available support. Resources include a history of convergence, a high-level overview of the differences between IFRS and U.S. GAAP, frequently asked questions, articles, textbooks, continuing professional education (CPE) courses and live conference training, helpful links, and assistance for audit committee members.

FASB Accounting Standards Codification™

.177 On January 15, 2008, FASB launched the verification period of FASB Accounting Standards Codification™ (ASC). FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing all authoritative literature in a topically organized structure. FASB ASC includes all accounting standards issued by a standard setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, AICPA, Emerging Issues Task Force (EITF), and related literature. FASB ASC also includes relevant authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance.

.178 The purpose of FASB ASC is not to change GAAP but rather to reorganize thousands of GAAP pronouncements into approximately 90 topics. At the end of the extended verification period, FASB is expected to formally approve FASB ASC as the single source of authoritative U.S. accounting and reporting
standards, other than guidance issued by the SEC. On July 1, 2009, FASB will supersede all then-existing
non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature
not included in the codification will become nonauthoritative. FASB ASC can be accessed at http://
asc.fasb.org/home. FASB ASC includes an industry section for investment companies.

.179 Constituents are encouraged to use FASB’s online FASB ASC Research System free of charge during
the verification period and provide feedback to FASB on the codification.

.180 The AICPA has published the Financial Reporting Alert FASB Codification Developments—2008
(product no. 029209kk). This Financial Reporting Alert is intended to provide a better understanding of
FASB ASC and outline its structure, as well as provide case studies on navigating the FASB ASC Research
System and performing accounting research.

Summary of Recent Accounting Pronouncements and Related Guidance

.181 Presented in the following table is a list of recently issued accounting pronouncements and related
guidance. This alert is intended to be used in conjunction with the Comprehensive Audit Risk Alert—2008
(product no. 022339kk); therefore, only industry specific pronouncements and related guidance or those of
specific significance to the industry are summarized herein. For information on accounting standards issued
subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org and the FASB
Web site at www.fasb.org. You also may look for announcements of newly issued standards in the CPA Letter
and Journal of Accountancy.

<table>
<thead>
<tr>
<th>Financial Accounting Standards Board (FASB) Statement No. 163</th>
<th>Accounting for Financial Guarantee Insurance Contracts—an interpretation of FASB Statement No. 60</th>
</tr>
</thead>
<tbody>
<tr>
<td>(May 2008)</td>
<td></td>
</tr>
<tr>
<td>FASB Statement No. 162</td>
<td>The Hierarchy of Generally Accepted Accounting Principles</td>
</tr>
<tr>
<td>(May 2008)</td>
<td></td>
</tr>
<tr>
<td>FASB Statement No. 161</td>
<td>Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133</td>
</tr>
<tr>
<td>(March 2008)</td>
<td></td>
</tr>
<tr>
<td>FASB Statement No. 160</td>
<td>Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51</td>
</tr>
<tr>
<td>(December 2007)</td>
<td></td>
</tr>
<tr>
<td>FASB Statement No. 141 (revised 2007)</td>
<td>Business Combinations</td>
</tr>
<tr>
<td>(December 2007)</td>
<td></td>
</tr>
<tr>
<td>FASB Statement No. 159</td>
<td>The Fair Value Option for Financial Assets and Financial Liabilities—including an amendment of FASB Statement No. 115</td>
</tr>
<tr>
<td>(February 2007)</td>
<td></td>
</tr>
<tr>
<td>FASB Statement No. 158</td>
<td>Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)</td>
</tr>
<tr>
<td>(September 2006)</td>
<td></td>
</tr>
<tr>
<td>FASB Statement No. 157</td>
<td>Fair Value Measurements</td>
</tr>
<tr>
<td>(September 2006)</td>
<td></td>
</tr>
</tbody>
</table>
## Recent Accounting Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Statement</th>
<th>Description</th>
</tr>
</thead>
</table>
| **FASB Interpretation No. (FIN) 48** (June 2006) | Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109  
FASB Staff Position (FSP) FIN 48-2, Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises, issued in February 2008, defers the effective date of FIN 48 for certain nonpublic enterprises, as defined in the FSP, to the annual financial statements for fiscal years beginning after December 15, 2007.  
(On December 17, 2008, FASB approved the issuance of an FSP further deferring the effective date of FIN 48 for certain nonpublic enterprises for an additional year. The text of the final FSP is not available as of the writing of this alert.) |
| **FASB Staff Positions (FSPs)** (Various dates) | Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs. |
| **AICPA Statement of Position (SOP) 07-1** (AICPA, Technical Practice Aids, ACC sec. 10,930) | Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies  
In February 2008, FASB issued FSP SOP 07-1-1, Effective Date of AICPA Statement of Position 07-1, which indefinitely defers the effective date of SOP 07-1. Entities that early adopted SOP 07-1 before December 15, 2007, are permitted, but not required, to continue to apply the provisions of the SOP. No other entities may adopt the provision of the SOP, subject to the exception in the following sentence: “If a parent entity that early adopted the SOP chooses not to rescind its early adoption, an entity consolidated by the parent entity that is formed or acquired after that parent entity’s adoption of the SOP must apply the provisions of the SOP in its standalone financial statements.” |
| **TIS section 6300.36** (AICPA, Technical Practice Aids) (Nonauthoritative) | This question and answer discusses when an insurance company may change its original policyholder benefit liability assumptions. |
| **TIS section 9150.25** (AICPA, Technical Practice Aids) (Nonauthoritative) | This question and answer discusses considerations when an accountant’s work efforts results in or contributes to the existence of financial statements. |
| **TIS section 1100.15** (AICPA, Technical Practice Aids) (Nonauthoritative) | This question and answer discusses auditing and accounting issues related to withdrawal restrictions placed on short term investments by a money market fund or its trustee. |
| **TIS sections 6910.25–.28** (AICPA, Technical Practice Aids) (Nonauthoritative) | These questions and answers discuss financial statement presentation considerations for investment companies. |

(continued)
Recent Accounting Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th><strong>TIS sections 6140.20–.22 (AICPA, Technical Practice Aids)</strong> (Nonauthoritative)</th>
<th>These questions and answers discuss not-for-profit organizations’ fund-raising expenses.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>TIS section 6931.08–.10 (AICPA, Technical Practice Aids)</strong> (Nonauthoritative)</td>
<td>These questions and answers discuss various employee benefit plan topics.</td>
</tr>
<tr>
<td><strong>AICPA Practice Guide (Nonauthoritative)</strong></td>
<td>Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48</td>
</tr>
</tbody>
</table>

.182 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance to the investment companies industry are briefly explained here. The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. The Comprehensive Audit Risk Alert—2008 (product no. 022339kk) and other AICPA industry-specific alerts also contain summaries of recent pronouncements that may not be discussed in this alert. To obtain copies of AICPA literature, call (888) 777-7077 or visit www.cpa2biz.com.

Recent AICPA Independence and Ethics Pronouncements

.183 The Audit Risk Alert Independence and Ethics Developments—2008 (product no. 022479kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

AICPA Interpretation No. 501-8

.184 Specifically, auditors should be aware of Interpretation No. 501-8, “Failure to Follow Requirements of Governmental Bodies, Commissions, or Other Regulatory Agencies on Indemnification and Limitation of Liability Provisions in Connection With Audit and Other Attest Services,” under Rule 501, Acts Discreditable (AICPA, Professional Standards, ET sec. 501 par. .09), which was adopted May 2008. This interpretation became effective July 31, 2008. The full text of the interpretation is available at www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/Exposure+Drafts++Standard+Setting/.

On the Horizon

.185 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to the investment companies industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.186 The following table lists the various standard setting bodies’ Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed in this alert. Readers should refer to information provided by the various standard-setting bodies for further information.
Auditing Pipeline—Nonissuers

ASB Clarity Project

.187 In response to growing concerns about the complexity of standards, the Auditing Standards Board (ASB) has commenced a large-scale “clarity” project to revise all existing auditing standards so they are easier to read and understand. Over the next two or three years, the ASB will be redrafting all of the existing auditing sections contained in the Codification of Statements on Auditing Standards (AU sections of the AICPA’s Professional Standards) to apply the clarity drafting conventions and converge with the International Standards on Auditing issued by the International Auditing and Assurance Standards Board (IAASB). The ASB proposes that, except to address current issues, all redrafted standards will become effective at the same time. Only those standards needing to address current issues would have earlier effective dates. The ASB believes that a single effective date will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. Currently, the date is expected to be for audits of financial statements for periods beginning no earlier than December 15, 2010. This date depends on satisfactory progress being made and will be amended, if necessary. See the “Clarity Project Explanatory Memorandum” and the discussion paper Improving the Clarity of ASB Standards at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+-+Clarity+of+ASB+Standards.htm.

Auditing Pipeline—Issuers

.188 Guidance issued by the PCAOB is included in the section of this alert titled “Summary of Recent Auditing and Attestation Pronouncements and Related Guidance”. For more information regarding recent developments at both the SEC and PCAOB, readers may refer to Audit Risk Alert SEC and PCAOB Developments—2008 (product no. 022499kk). In addition, we would like to alert you to two PCAOB projects.

.189 In October 2008, the PCAOB proposed seven new auditing standards, which will be available for comment through February 18, 2009, to update and supersede the current risk assessment standards. The PCAOB chairman noted the proposals demonstrate the view that the risk of fraud is a central part of the audit process and not a separate consideration. The proposed standards integrate the risk assessment standards with the standard for the audit of internal control over financial reporting. Many of the IAASB’s risk assessment standards were utilized in creating these proposed standards, and efforts were made to reduce any unnecessary differences. These proposed standards each have a statement of objective for the auditor, which is loosely adapted from the international auditing standards. This is an example of the move in the United States from rules-based to principles-based accounting and auditing standards because these objectives do not state required outcomes. The seven proposed standards are as follows:
Additionally, in February 2008, the PCAOB proposed a new auditing standard on engagement quality review and a conforming amendment to its interim quality control requirements. The proposed standard is risk based and designed to increase the likelihood that engagement deficiencies will be identified and corrected prior to the issuance of the auditor’s report. The proposed standard provides a firmer framework for an engagement quality reviewer to objectively evaluate the significant judgments made by the engagement team and the conclusions reached in forming the overall conclusion on the engagement and preparing the engagement report. The comment period ended May 12, 2008.

These proposed standards can be accessed at www.pcaobus.org/Standards/Proposed_Standards_and_Related_Rules.aspx. Auditors should be alert to further developments, including the issuance of any final standards.

**Accounting Pipeline**

A number of accounting projects and pronouncements are currently in progress. For a summary of significant accounting projects and pronouncements, refer to the Comprehensive Audit Risk Alert—2008 (product no. 022339kk). Such in-progress issues include the following:

- Accounting for hedging activities exposure draft
- Accounting for contingencies exposure draft
- Transfers of financial assets project and amendments to FIN 46 (revised December 2003), Consolidation of Variable Interest Entities—an interpretation of ARB No. 51, exposure drafts, together with an interim FSP to enhance related disclosures (final FSP FAS 140-4 and FIN 46(R)-8, Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities, issued December 11, 2008)
- Going concern and subsequent events exposure drafts, issued as part of FASB ASC
- Phase 2 of the fair value project
- Earnings per share convergence project
- Income tax convergence project
- Leases project
- Reporting discontinued operations project

**Proposed FASB EITF Issues and Staff Positions**

Proposed FASB EITF Issues. Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

Proposed FSPs. A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information. Some proposed FSPs of particular interest to the investment companies industry include the following:
Proposed FSP ARB 43-a, Amendment of the Inventory Provisions of Chapter 4 of ARB No. 43
Proposed FSP FAS 157-c, Measuring Liabilities under FASB Statement No. 157
Proposed FSP FAS 107-a, Disclosures about Certain Financial Assets: An Amendment of FASB Statement No. 107
Proposed FSP FAS 141(R)-a, Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies

Resource Central

The following are various resources that practitioners engaged in the investment companies industry may find beneficial.

Publications

Practitioners may find the following publications useful. Choose the format best for you—online, print, or CD-ROM:

- Audit and Accounting Guide Investment Companies (2008) (product no. 012628kk [paperback], WIN-XXkk [online with the associated Audit Risk Alert], or DIN-XXkk [CD-ROM with the associated Audit Risk Alert])
- Audit Guide Analytical Procedures (2008) (product no. 012558kk [paperback], WAN-XXkk [online], or DAN-XXkk [CD-ROM])
- Audit Guide Assessing and Responding to Audit Risk In a Financial Statement Audit (2006) (product no. 012456kk [paperback] or WRA-XXkk [online])
- Audit Guide Auditing Derivative Instruments, Hedging Activities, and Investments in Securities (2008) (product no. 012528kk [paperback], WDI-XXkk [online], or DDI-XXkk [CD-ROM])
- Audit Guide Audit Sampling (2008) (product no. 012538kk [paperback], WAS-XXkk [online], or DAS-XXkk [CD-ROM])
- Audit Guide Service Organizations: Applying SAS No. 70, as Amended (2008) (product no. 012778kk [paperback], WSV-XXkk [online], or DSV-XXkk [CD-ROM])
- Comprehensive Audit Risk Alert—2008 (product no. 022339kk [paperback], WGE-XXkk [online], or DGE-XXkk [CD-ROM])
- Audit Risk Alert Compilation and Review Developments—2008 (product no. 022309kk [paperback], WCR-XXkk [online], or DCR-XXkk [CD-ROM])
- Audit Risk Alert Independence and Ethics Developments—2008 (product no. 022479kk [paperback], WIA-XXkk [online], or DIA-XXkk [CD-ROM])
- Audit Risk Alert SEC and PCAOB Developments—2008 (product no. 022499kk [paperback])
- Audit Risk Alert Understanding the New Auditing Standards Related to Risk Assessment (product no. 022526kk [paperback])
- Checklists and Illustrative Financial Statements for Investment Companies (product no. 008949kk [paperback] or WIS-CLkk [online])
- Audit and Accounting Manual (2008) (product no. 005138kk [paperback], WAM-XXkk [online], or AAM-XXkk [loose leaf])
- Accounting Trends & Techniques, 62nd Edition (product no. 009900kk [paperback] or WAT-XXkk [online])
Additional resources for accountants in business and industry are the Financial Reporting Alert series, designed to be used by members of an entity’s financial management and audit committee to identify and understand current accounting and regulatory developments affecting the entity’s financial reporting.

- Financial Reporting Alert *Current Accounting Issues and Risks—2008* (product no. 029208kk [paperback])
- Financial Reporting Alert *FASB Codification Developments—2008* (product no. 029209kk [paperback])

AICPA reSOURCE: Accounting and Auditing Literature

The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm’s needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to the AICPA’s latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides (more than 20), Audit Risk Alerts (more than 15), and *Accounting Trends & Techniques*. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Continuing Professional Education

The AICPA offers a number of CPE courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA’s Annual Accounting and Auditing Update Workshop (2008–2009 Edition)* (product no. 736184kk [text] or 187192kk [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *SEC Reporting* (product no. 736775kk [text] or 186756kk [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements and gives you examples and tips for ensuring compliance.
- *International Versus U.S. Accounting: What in the World is the Difference?* (product no. 731666kk [text]). With the fast pace of the convergence project, understanding the differences between IFRS and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRS and U.S. GAAP.
- *The International Financial Reporting Standards: An Overview* (product no. 157220kk [online] or 739750HSkk [DVD]). This course captures a live presentation on IFRS given to the AICPA Board of Directors.

Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz, is the AICPA’s flagship online learning product. AICPA members pay $180 for a new subscription and $149 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics.

To register or learn more, visit www.cpa2biz.com.

Webcasts

Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession’s leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.
CFO Quarterly Roundtable Series

.204 The CFO Quarterly Roundtable Series, brought to you each calendar quarter via webcast, covers a broad array of “hot topics” that successful organizations employ and subjects that are important to the CFO’s personal success. From financial reporting, budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.205 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession’s leading experts on what is “hot” at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you “plugged in” to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

IFRS Quarterly Webcast Series

.206 The IFRS Quarterly Webcast Series, brought to you each calendar quarter, is part of a multistep educational process to get practitioners, financial managers, and auditors up to speed on all aspects of IFRS implementation. Over the course of the quarterly series, IFRS standards will be covered in depth. International harmonization is quickly approaching, and this series will help both accountants and auditors stay abreast of the developments and changes they will need to implement.

Member Service Center

.207 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.208 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA’s Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. Beginning January 14, 2008, hotline hours have been extended so that the hotline is now available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/.

Ethics Hotline

.209 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA’s Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

Industry Conference

.210 The AICPA sponsors an annual National Conference on the Securities Industry in the fall or winter. The National Conference on the Securities Industry is a two day conference designed to update attendees on recent developments related to the securities industry. Cosponsored by the AICPA and the Financial Management Division of the Securities Industry and Financial Markets Association, it’s the most comprehensive update in accounting, tax, and regulatory matters delivered by key individuals and regulators of
the SEC, the Financial Industry Regulatory Authority, and FASB. This conference is an ideal opportunity to engage in questions and answers with leading industry experts and offers a powerful way to network with peers, speakers, and officials from government agencies. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

The CAQ

.211 The CAQ was created to serve investors, public company auditors, and the markets. The CAQ’s mission is to foster confidence in the audit process and aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession’s core values of integrity, objectivity, honesty, and trust.

.212 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit, or are interested in auditing, public companies with education, communication, representation, and other means. To learn more about the CAQ, visit http://thecaq.aicpa.org.

AICPA Industry Expert Panel—Investment Companies

.213 For information about the activities of the AICPA Investment Companies Industry Expert Panel, visit the panel’s Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_investco.htm.

Industry Web Sites

.214 The Internet covers a vast amount of information that may be valuable to auditors of investment companies entities, including current industry trends and developments. Some of the more relevant sites for auditors with investment companies clients include those shown in the following table:

<table>
<thead>
<tr>
<th>Organization</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commodity Futures Trading Commission</td>
<td><a href="http://www.cftc.gov/">www.cftc.gov/</a></td>
</tr>
<tr>
<td>Financial Accounting Standards Board</td>
<td><a href="http://www.fasb.org/">www.fasb.org/</a></td>
</tr>
<tr>
<td>Financial Industry Regulatory Authority</td>
<td><a href="http://www.finra.org/index.htm">www.finra.org/index.htm</a></td>
</tr>
<tr>
<td>Independent Directors Council</td>
<td><a href="http://www.idc1.org">www.idc1.org</a></td>
</tr>
<tr>
<td>Investment Company Institute</td>
<td><a href="http://www.ici.org/">www.ici.org/</a></td>
</tr>
<tr>
<td>Mutual Fund Directors Forum</td>
<td><a href="http://www.mfdf.com/">www.mfdf.com/</a></td>
</tr>
<tr>
<td>Securities and Exchange Commission</td>
<td><a href="http://www.sec.gov/">www.sec.gov/</a></td>
</tr>
</tbody>
</table>

.215 The investment company practices of some of the larger CPA firms also may contain industry-specific auditing and accounting information that is helpful to auditors.

* * *
.216 This Audit Risk Alert replaces Investment Companies Industry Developments—2007/08.

.217 The Audit Risk Alert Investment Companies Industry Developments is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year’s Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org or write to

A&A Publications
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110
Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

<table>
<thead>
<tr>
<th>Web Site Name</th>
<th>Content</th>
<th>Web Site</th>
</tr>
</thead>
</table>
| American Institute of CPAs (AICPA) | Summaries of recent auditing and other professional standards as well as other AICPA activities | www.aicpa.org  
www.cpa2biz.com  
www.ifrs.com |
<p>| AICPA Accounting Standards Executive Committee (AcSEC) | Issues guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things | <a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards</a> |
| AICPA Accounting and Review Services Committee (ARSC) | Develops and issues review and compilation standards and interpretations | <a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee</a> |
| AICPA Professional Issues Task Force (PITF) | Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts | <a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force</a> |
| Economy.com | Source for analyses, data, forecasts, and information on the U.S. and world economies | <a href="http://www.economy.com">www.economy.com</a> |
| The Federal Reserve Board | Key interest rates | <a href="http://www.federalreserve.gov">www.federalreserve.gov</a> |
| Financial Accounting Standards Board (FASB) | Summaries of recent accounting pronouncements and other FASB activities | <a href="http://www.fasb.org">www.fasb.org</a> |
| USA.gov | Portal through which all government agencies can be accessed | <a href="http://www.usa.gov">www.usa.gov</a> |
| Governmental Accounting Standards Board (GASB) | Summaries of recent accounting pronouncements and other GASB activities | <a href="http://www.gasb.org">www.gasb.org</a> |
| International Accounting Standards Board (IASB) | Summaries of International Financial Reporting Standards and International Accounting Standards | <a href="http://www.iasb.org">www.iasb.org</a> |</p>
<table>
<thead>
<tr>
<th><strong>Web Site Name</strong></th>
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<th><strong>Web Site</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>International Auditing and Assurance Standards Board (IAASB)</td>
<td>Summaries of International Standards on Auditing</td>
<td><a href="http://www.iaasb.org">www.iaasb.org</a></td>
</tr>
<tr>
<td>International Federation of Accountants (IFAC)</td>
<td>Information on standards setting activities in the international arena</td>
<td><a href="http://www.ifac.org">www.ifac.org</a></td>
</tr>
<tr>
<td>Private Company Financial Reporting Committee (PCFRC)</td>
<td>Information on the initiative to further improve FASB’s standard setting process to consider needs of private companies and their constituents of financial reporting</td>
<td><a href="http://www.pcfrc.org">www.pcfrc.org</a></td>
</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
<td>Information on accounting and auditing activities of the PCAOB and other matters</td>
<td><a href="http://www.pcaob.org">www.pcaob.org</a></td>
</tr>
</tbody>
</table>

[The next page is 8355.]
AAM Section 8110

Securities Industry Developments—2008

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of brokers and dealers in securities with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. Because securities brokers and dealers often deal in commodity futures or function as commodity pool operators, this Audit Risk Alert expands the discussion of recent developments to include matters that may affect audits of commodity entities as well.

This publication is an other auditing publication as defined in AU section 150, Generally Accepted Auditing Standards (AICPA, Professional Standards, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Susan M. Reed, CPA
Technical Manager
Accounting and Auditing Publications

Acknowledgments

The AICPA staff is grateful to the following individuals for their essential contributions in creating this publication: Anthony Anzevino, Ronald Carletta, Al Goll, Dipti Gulati, G. Victor Johnson, Andrew Labadie, Anthony Lucarelli, and Paul Nockels.

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your securities industry audits. This alert can also be used by an entity’s internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool in helping you identify the significant risks that may result in the material misstatement of financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This alert is intended to be used in conjunction with the Comprehensive Audit Risk Alert—2008 (product no. 022339kk). This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.
Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor’s understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity’s financial performance
- Internal control, which includes the selection and application of accounting policies

The securities industry may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

The auditor should obtain an understanding of the entity’s objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity’s ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity’s business is also dynamic, and the entity’s strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client’s environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic and Industry Developments

The State of the Economy

When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on the entity’s financial statements being audited.

Unprecedented Events in the Financial Markets

During 2008, unprecedented events occurred in the financial markets, including the failure of a major investment bank, acquisitions of several investment and commercial banks (including some that required...
assistance from federal agencies), and the placement into conservatorship of Fannie Mae and Freddie Mac. Further, several foreign financial institutions received assistance from their national governments, or entered into similar acquisition agreements. Additionally, on September 17, 2008, a significant, publicly registered money market fund declined below the industry standard of $1.00 per share on a market value basis due to a combination of holdings of short-term securities issued by the failed investment bank and major shareholder redemptions. As a result of these events, the condition of the fixed income markets worsened. Corporations and financial institutions generally recognized as creditworthy began experiencing difficulty borrowing money in the financial markets for any period of time longer than an overnight basis.

Development of New Alert to Address Current Market Conditions

.10 In light of the economic situation, the AICPA has developed a dedicated alert to address common accounting and auditing concerns relative to current market conditions. The alert, Current Economic Crisis: Accounting and Auditing Considerations—2009, discusses a number of relevant topics and includes resources to assist in fair value accounting and its associated audit risks. Please visit www.cpa2biz.com for upcoming AICPA products, including the alert mentioned here, to help navigate this trying time.

Basic Measures of Economic Activity—Gross Domestic Product, Unemployment, and Interest Rates

.11 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.2 percent in 2007. According to 2008 third quarter final estimates, real GDP decreased at an annual rate of 0.5 percent, which is down significantly from the 2.8 percent increase in real GDP during the second quarter of 2008.

.12 The unemployment rate remained relatively unchanged during 2007, holding between 4.4 percent and 5.0 percent, with an annual average rate of 4.6 percent. However, during 2008, the unemployment rate rose dramatically. As of December 2008, the unemployment rate reached its highest level in 2008 at 7.2 percent, representing approximately 11.1 million people.

.13 The target for the federal funds rate remained stable at 5.25 percent from June 2006 to September 2007 when the Federal Reserve began decreasing rates. Since the first rate decrease in September 2007, the Federal Reserve has decreased rates more than 5.0 percentage points to less than 0.25 percent as of mid-December 2008. The Federal Reserve noted in its December press release that since October 2008, labor market conditions have deteriorated and the available data indicate that consumer spending, business investment, and industrial production have declined. Financial markets remain quite strained and credit conditions tight. Overall, the outlook for economic activity has weakened further. Inflationary pressures have diminished appreciably and are expected to continue to moderate. The Federal Open Market Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time.


.15 The EESA is intended to restore financial sector liquidity and stability, protect the value of taxpayer assets (such as homes, savings, and retirement funds), and provide a return to taxpayers. The EESA authorizes the Treasury secretary to establish the Troubled Assets Relief Program (TARP), whereby the U.S. Treasury can purchase troubled assets from financial institutions, and authorizes $700 billion as requested by the Treasury secretary for the implementation of TARP. Upon authorization of TARP, up to $350 billion became available for immediate use. The secretary is required to examine the long-term viability of an
institution in determining whether to directly purchase assets under TARP. Financial institutions participating in TARP will be subject to certain restrictions on executive compensation.

.16 The injection of capital into banks was announced on October 14, 2008, and was named the Capital Purchase Program (CPP). Under the CPP, the Treasury proposed to invest up to $250 billion in senior perpetual preferred stock and warrants in qualifying financial institutions. In November 2008, the Treasury completed its $125 billion aggregate investment in the nine banking organizations deemed to be systemically important. Funds received from the CPP will be includible in an institution’s tier one capital without limitation. Other institutions were required to apply by November 14, 2008, to their appropriate federal banking agency for participation in the program. The deadline for nonpublic stock institutions and mutual banks has been extended as the Treasury develops term sheets applicable to these institutions.

.17 In summary, the primary components of the EESA include (a) an allocation of $700 billion to stabilize the U.S. financial system; (b) creation of an oversight board, executive compensation rules, and other corporate governance rules for any entities that participate; (c) increase of the statutory limit on public debt from $10.0 trillion to $11.3 trillion; (d) temporary increase of Federal Deposit Insurance Corporation (FDIC) insurance limits; (e) creation of a tax modification for Fannie Mae and Freddie Mac stock losses; (f) restatement of the Security and Exchange Commission’s (SEC’s) authority to suspend the application of Financial Accounting Standards Board (FASB) Statement No. 157, Fair Value Measurements; and (g) the requirement of the SEC to conduct a study on the impact and effects of FASB Statement No. 157.

.18 For additional information on the EESA and its related programs, see http://treasury.gov/initiatives/eesa/. On that Web site, you may also sign up for EESA e-mail alerts to receive notification about current developments.

Industry Trends and Conditions

Continuing Market Stress

.19 As mentioned previously, recent conditions in the financial markets have sent shockwaves through the industry, the country, and global markets. In October, 2008, the U.S. and certain overseas trading markets experienced several record one-day percentage increases and decreases. At the time of this writing the markets continue to be extremely volatile. The financial market turmoil, credit crisis, and resultant federal bailouts are daily headlines as the U.S. government attempts to stabilize the economic situation.

.20 During 2008, fixed-income markets continued under severe stress (beginning with effects of subprime mortgage-backed securities and extending to asset-backed commercial paper) to the extent that they began to place significant stress on financial markets in general. A number of major financial institutions significantly exposed to distressed sectors of the markets were hard-hit, most dramatically demonstrated by the absorption of Bear Stearns Companies by JPMorgan Chase & Co., additional support provided by the federal government to Fannie Mae and Freddie Mac, and the failure of Lehman Brothers and AIG.

.21 Of further importance to the markets, the credit ratings of major “monoline” bond insurers, including MBIA Inc. and Ambac Financial Group, Inc., were downgraded by the major rating agencies from their previous AAA levels, due to significant exposure to losses from insurance written on asset-backed securities. Certain less significant insurers experienced rating declines to “below-investment-grade” (or “junk”) status. This, in turn, resulted in the extension of market illiquidity to municipal and other corporate securities, for which bond insurance plays an integral role.

.22 Because of the losses and capital reductions incurred by market-makers in auction-rate debt and preferred stock, and, to a lesser extent, questions about the financial strength of bond insurers who supported the credit of certain auction-rate security issuers, numerous auctions failed beginning in February 2008. These markets continue to struggle as of the writing of this alert. As a result, some municipal bond
issuers paid unusually high interest rates as required by their bond indentures in the event of failed auctions.

.23 This distress also found its way into the broader corporate loan and bond markets, with financial institutions reducing funds available for lending and tightening lending standards. At times this resulted in the withdrawal of commitments to provide loans intended for corporate acquisitions and refinancings. Further, defaults among bond issuers have generally increased. Standard & Poor’s (S&P) reported that, through November 11, 2008, 85 companies worldwide defaulted on their debt affecting a total of $284 billion. This is a significant increase from the previous two years (22 defaults in 2007 and 30 in 2006). Of the 85 companies, 70 are based in the United States.

.24 Finally, significant questions arose regarding the procedures used by bond rating agencies to evaluate asset-backed securities, in particular “AAA” ratings granted to securities, including securities acquired by SEC-registered money market funds, that later experienced significant credit-related deterioration. As a result, the SEC has reconsidered the inclusion of specific references to ratings by nationally-recognized statistical rating organizations in its rules and forms out of concern that doing so (as stated in SEC communications) “has, in effect, placed an ‘official seal of approval’ on ratings that could adversely affect the quality of due diligence and investment analysis,” and proposed a number of amendments to “reduce undue reliance on credit ratings and result in improvement in the analysis that underlies investment decisions.”

.25 Variations of the financial market turmoil in the United States are being felt in countries around the world. Global markets have experienced similar challenges and conditions as those found in this country, which have highlighted how interdependent the global economy is.

.26 These times present unprecedented challenges for auditors and the companies they audit. The issues and “happenings” change almost daily at this point. Therefore, this section of the alert will focus primarily on actions that can be taken in response to the general situation. Overall, the turmoil in the financial markets and the economy in general warrant increased scrutiny by the auditor to ensure that he or she understands the many issues that could impact the entity under audit. Specific audit considerations are discussed in the “Audit and Attestation Issues and Developments” section of this alert.

The Securities Industry

.27 Record high levels were reached during 2007 in both the Dow Jones Industrial Average (DJIA) and the Standard & Poor’s 500 Index (S&P 500). On October 9, 2007 the DJIA hit a record high level, closing at 14,164.53. Also on that date, the S&P 500 closed at an all time high of 1,565.01.

.28 During the later part of 2007, the DJIA fluctuated somewhat but closed out 2007 at 13,264.82. The first two quarters of 2008 saw the DJIA fluctuating between approximately 11,000 and 13,197.43 (the high for 2008 that was reached on January 3, 2008). The first quarter of 2008 closed at 12,262.89, and the second quarter of 2008 closed at 11,350.01. During September 2008 the DJIA dropped, with an all time record loss of 777.68 points occurring on September 29, 2008. On that date the DJIA closed at 10,365.45. The third quarter closed at 10,850.66 on September 30, 2008.

.29 Between September 29, 2008, and the end of the year, the DJIA fluctuated significantly, with the result being a significant decrease. Record percentage losses and gains occurred during that time period. On October 13, 2008, the largest point gain in history occurred when the DJIA increased by 936.42 points, closing at 9,387.61. Then, on October 15, 2008, a record percentage loss occurred with the DJIA decreasing 7.87 percent, closing at 8,577.91. A low point was reached for the year on November 21, 2008, with the DJIA closing at 7,392.27. The DJIA closed out 2008 at 8,776.39.

.30 The NASDAQ, Inc. (NASDAQ) started out 2008 at 2,652.28 and ended 2008 at 1,577.03. The high for the year occurred on January 3, 2008, when it closed at 2,634.27. The low for the year occurred on November 21, 2008, when the NASDAQ closed at 1,295.48.

What 2009 will bring is as uncertain as the current economy. For more information on the markets, please refer to the Securities Industry and Financial Markets Association (SIFMA) research reports, which can be accessed at www.sifma.org/research/research_reports.html.

The Commodities Industry

Global futures and options contract volume has continued to increase through 2007 and into 2008. In the first 10 months of 2008, volume on U.S. futures exchanges reached 6.1 billion contracts, a 22 percent increase from the same period in 2007. The volume of contracts traded on foreign exchanges increased 13 percent compared to the first 10 months of 2007. Trading volume in interest rate and equity products accounted for more than 70 percent of worldwide trading volume in both periods.

The growth in futures volume and markets is further reflected in increased customer funds held by entities registered with the Commodity Futures Trading Commission (CFTC) as futures commission merchants (FCMs) for trading on U.S. and foreign futures and options exchanges. The total amounts required under CFTC regulations to be held in segregated or secured accounts on behalf of FCM customers increased by $49 billion from approximately $163 billion as of October, 2007, to approximately $212 billion as of October 31, 2008.

The U.S. futures industry, in addition to the increasing volume and customer participation, also has experienced other significant changes in 2008. In 2008, the CME Group enhanced its position as the world’s largest financial exchange by acquiring the New York Mercantile Exchange, creating a company that will dominate the U.S. derivatives sector with control of 98 percent of U.S. listed futures. The CME Group also includes the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade, the two largest contract markets designated by the CFTC. Clearing rules and safeguards will be harmonized as integration of operations proceeds among the merged entities.

Legislative and Regulatory Developments

Regulatory Update—PCAOB

On January 8, 2009, the Public Company Accounting Oversight Board (PCAOB) released a statement that provides information for auditors of nonpublic broker-dealers regarding the PCAOB’s registration process. Registration with the PCAOB of auditors of nonpublic broker-dealers had not been necessary under SEC rules. However, the SEC’s rule governing such registration recently expired. Without new action by the SEC, financial statements of nonpublic broker-dealers for fiscal years ending after December 31, 2008, must be certified by a registered public accounting firm. To apply for registration with the PCAOB, a firm must complete an electronic application form and pay an application fee. Visit www.pcaobus.org/Registration for information. Readers should remain alert to future developments.

Regulatory Update—SEC

SEC Developments

The SEC has taken a number of actions in response to the current financial market’s turmoil and the events leading up to it. This alert will discuss some of the SEC’s actions, but readers should refer to the SEC’s Web site, SEC Actions During Turmoil in Credit Markets, for more information on actions taken during the current crisis (www.sec.gov/news/press/sec-actions.htm.) See the “Accounting Issues and Developments” section for a discussion of the results of the congressionally mandated study on fair value.
Enforcement Actions and Emergency Orders

.38 In a press release dated October 22, 2008, the SEC released fiscal year 2008 enforcement results noting the second highest number of enforcement actions in agency history took place in fiscal year 2008. During that period an increase was noted in the amount of cases related to market manipulation and insider trading. Previously, in September 2008, the SEC announced a sweeping expansion of its ongoing investigation into possible market manipulation in the securities of certain financial institutions. A number of high profile enforcement actions are included on the SEC Actions During Turmoil in Credit Markets Web site. (See the “Consideration of Fraud” section following for an example.) Additionally, the SEC’s 2008 enforcement results are included in its 2008 Performance and Accountability Report at www.sec.gov/about/secpar2008.shtml.

.39 The SEC issued a number of emergency orders to help stabilize financial markets. Many of these emergency orders related to short selling. In addition, the SEC chairman asked the U.S. Congress to provide the statutory authority necessary for government oversight of the credit default swap market. The SEC also entered into a Memorandum of Understanding with the Federal Reserve and the CFTC to make sure that key federal financial regulators share information and coordinate regulatory activities where appropriate.

Financial Statement Disclosures

.40 The SEC also took action in 2008 to further enhance the transparency of financial statement disclosures. In June 2008 the SEC established the 21st Century Disclosure Initiative (initiative). The initiative’s goal is to develop a modernized disclosure system that utilizes technology and better meets the marketplace’s needs. As part of the initiative it will rethink financial disclosures by examining the basic purpose of disclosures from the investor and market point of view and to create a plan to revise the current forms-based disclosure system. Readers can keep up to date with the progress of this initiative by visiting www.sec.gov/spotlight/disclosureinitiative.shtml.

Management’s Discussion and Analysis

.41 In addition to this initiative, to date the SEC has sent three sample letters to certain public companies identifying a number of disclosure issues to consider in preparing management’s discussion and analysis (MD&A) for upcoming annual reports. These sample letters are available at www.sec.gov/news/press/sec-actions.htm, and are as follows:

- Sample Letter Sent to Public Companies That Have Identified Investments in Structured-Investment Vehicles, Conduits or Collateralized Debt Obligation (Off-balance Sheet Entities)—sent December 2007
- Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of FASB Statement No. 157 (Fair Value Measurements)—sent March 2008
- Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of FASB Statement No. 157 (Fair Value Measurements)—updated letter sent September 2008

Consolidated Supervised Entities Program

.42 On September 26, 2008, the SEC announced a decision by the Division of Trading and Markets to end the Consolidated Supervised Entities (CSE) program, created in 2004 as a way for global investment bank conglomerates that lacked a supervisor under the law to voluntarily submit to regulation. Although the SEC had concluded that the CSE program did not work, it also concluded that the program was not needed to fill a regulatory gap: the major investment banks that had been a part of the CSE program have been reconstituted within a bank holding company subject to statutory supervision by the Federal Reserve.
SEC Final Rules

.43 The SEC has issued a number of final rules during 2008; rules specifically related to the securities industry or especially significant are summarized in the following paragraphs. Visit the SEC Web site at www.sec.gov for a complete list and the full content of the rules.

Nonaccelerated Filers Requirement to File Auditor’s Attestation Report on Internal Control Over Financial Reporting

.44 On June 26, 2008, the SEC issued a final rule (SEC Release No. 33-8934, Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers) extending the date on which nonaccelerated filers will be required to file the auditor’s attestation report on internal control over financial reporting when it files an annual report. Under an amendment of the temporary rules, nonaccelerated filers will be required to provide attestation reports in their annual reports for fiscal years ending on or after December 15, 2009.

Short Sales Rules

.45 During October 2008, the SEC issued two final rules related to short sales. The first, “Naked” Short Selling Antifraud Rule (SEC Release No. 34-58774), is an antifraud rule (Rule 10b-21) aimed at short sellers, including brokers and dealers acting for their own accounts who deceive specified persons, such as a broker or dealer, about their intention or ability to deliver securities in time for settlement and who fail to deliver securities by the settlement date. Though abusive “naked” short selling as part of a manipulative scheme is always illegal under the general antifraud provisions of the federal securities laws, this rule further evidences the liability of persons who deceive others about their intention or ability to deliver securities in time for settlement, including persons who deceive their brokers or dealers about their source of borrowable shares for the purpose of complying with Regulation SHO’s locate requirement.

.46 Amendments to Regulation SHO (SEC Release No. 34-58775) was adopted with the intention of further reducing the number of persistent fails to deliver in certain equity securities by eliminating the options market maker exception to the close-out requirement of Regulation SHO.

.47 In addition to the final rules mentioned previously, two interim final temporary rules were issued relating to short sales. The first, Amendments to Regulation SHO (SEC Release No. 34-58773) is intended to address abusive naked short selling in all equity securities by requiring that participants of a clearing agency registered with the SEC deliver securities by the settlement date, or if the participants have not delivered shares by the settlement date, immediately purchase or borrow securities to close out the fail to deliver position by no later than the beginning of regular trading hours on the settlement day following the day the participant incurred the fail to deliver position. This rule is effective from October 17, 2008, through July 31, 2009.

.48 The second interim final temporary rule, Disclosure of Short Sales and Short Positions by Institutional Investment Managers, (SEC Release No. 34-58785) requires certain institutional investment managers to file information on Form SH concerning their short sales and positions of section 13(f) securities other than options. This rule extends the reporting requirements established by earlier emergency orders with some modifications. This rule is effective from October 18, 2008, through August 1, 2009.

Regulatory Update—CFTC

.49 The following summarizes certain amendments to regulations and interpretations of the CFTC and other regulatory guidance issued or that became effective in the latter part of 2007 and in 2008. The amendments affected the financial reporting requirements of registered FCMs, and also of introducing brokers (IBs) that are not guaranteed by FCMs. The amendments and the other items discussed in the following paragraphs can be accessed at the CFTC Web site at www.cftc.gov.
CFTC staff expects to issue for comment proposed rule changes to simplify procedures relating to using other than U.S. generally accepted accounting principles (GAAP) in commodity pools’ audited financial statements, to extend filing dates for funds of funds, and to streamline reporting for multiple class funds. It plans to make the rule changes applicable to 2008 annual reports.

CFTC Reauthorization Act of 2008

In 2008, congress enacted legislation in the CFTC Reauthorization Act of 2008 (Reauthorization Act) that reauthorized the CFTC and gave the agency additional regulatory and enforcement tools necessary to continue to effectively oversee the dynamic futures industry, particularly transactions in energy products and foreign currency. The CFTC legislation includes the following major provisions:

- Reflect the CFTC's recommendation to the U.S. Congress on the need for additional tools to oversee trading on exempt commercial markets (ECMs).
- Provide the agency with essential oversight over contracts trading on ECMs—a type of electronic trading facility offering (among other things) energy derivatives products. Under prior law, ECMs were not subject to full CFTC regulatory authority. The new legislation outlines criteria for when an ECM contract should be considered a significant price discovery contract (SPDC) and gives the CFTC the authority to
  - require large trader position reporting for SPDCs.
  - require an ECM to adopt position limits or accountability levels for SPDCs.
  - require an ECM to exercise self-regulatory responsibility over SPDCs in order to prevent manipulation (among other things).
  - exercise emergency authority regarding SPDC transactions.
- Enhance agency authority over off-exchange retail foreign currency fraud by
  - clarifying that the CFTC’s antifraud authority applies to certain retail off-exchange foreign currency transactions (also known as the “Zelener fix”).
  - creating a new registration category for retail foreign exchange dealers and requiring registration for those who solicit orders, exercise discretionary trading authority, and operate commodity pools with respect to off-exchange retail foreign currency transactions.
  - imposing minimum capital requirements for futures commission merchants and retail foreign exchange dealers that act as counterparties in such transactions.
- Increase civil penalties for manipulation and certain other violations of the Commodity Exchange Act to $1 million per violation.
- Reauthorize the CFTC through the year 2013.
- Require implementation of SPDC provisions:
  - As outlined in the bill, the CFTC will propose a rule regarding the standards for SPDCs within 180 days of enactment and will implement a final rule within 270 days. The CFTC will identify significant price discovery contracts within 180 days after the final rule is in effect.

CFTC Concerns

Auditing Regulatory Supplementary Schedules

CFTC Regulation 1.16(d), Audit objectives, states, “The audit must include all procedures necessary under the circumstances to enable the independent licensed or certified public accountant to express an opinion on the financial statements and schedules.” Auditors should review and test an FCM’s segregation
and capital computations even if the amounts are considered immaterial in relation to the financial statements taken as a whole. Indeed, when Regulation 1.16, *Qualifications and reports of accountants*, was adopted, the CFTC commented that auditors must review such computations as part of a “proper audit.”

### Maintenance of Minimum Financial Requirements and Notification Requirements

.53 CFTC Regulation 1.17, *Minimum financial requirements for futures commission merchants and introducing brokers*, specifies minimum capital requirements and CFTC Regulation 1.12, *Maintenance of minimum financial requirements by futures commission merchants and introducing brokers*, specifies the conditions requiring FCMs to give notice of certain events occurring in a firm’s financial or operational condition, changes or anticipated changes in capital balances, and how and when such notices are to be given. For example, Regulation 1.12(g) requires that an FCM provide written notice of a substantial reduction in capital as compared to that last reported in a financial report filed with the CFTC pursuant to Regulation 1.10, *Financial reports of futures commission merchants and introducing brokers*. If an event or series of events, such as a withdrawal of equity capital, would cause a reduction of excess adjusted net capital of 30 percent or more, notice must be provided at least two days prior to the withdrawal. For any reduction in net capital of 20 percent or more, notice must be provided within two days of the event(s) causing the reduction.

.54 FCMs should establish procedures to ensure that the notices required by CFTC regulations are filed with the CFTC within the established time frames set forth in the regulations. Particularly, it is a violation of CFTC rules for an FCM not to file notice of a withdrawal of equity capital of 30 percent or more or at least two days prior to such withdrawal. Some FCMs have filed the notice after filing the financial statements in which the withdrawal is reflected. Doing that negates the purpose of the rule, which is designed to alert the CFTC to a possible change in an FCM’s financial condition. Notices should be filed promptly when due and provide an explanation for the decrease in net capital.

.55 FCMs should also consider including details in the comments section of the electronically filed financial report affected by reporting when they have made or intend to make the filing required by Regulation 1.12(g).

### Segregation of Customer Funds in Multiple Currencies

.56 FCMs must maintain compliance with CFTC recordkeeping, computation, and segregation requirements applicable to customer funds held in multiple currencies. Regulation 1.20, *Customer funds to be segregated and separately accounted for*, requires that all customer funds be separately accounted for and segregated as belonging to commodity customers and deposited in an account that clearly identifies those funds as such. Regulation 1.32, *Segregated account; daily computation and record*, requires each FCM to compute as of the close of each business day, on a currency-by-currency basis: (1) The total amount of customer funds on deposit in segregated accounts on behalf of commodity and commodity option customers; (2) the amount of such customer funds required to be on deposit in segregated accounts; and (3) the amount of the FCM’s residual interest in such customer funds.

.57 CFTC Regulation 1.49, *Denomination of customer funds and location of depositaries*, specifies the conditions under which the FCM’s obligations to a customer may be denominated in currencies other than the U.S. dollar. The regulation also specifies the geographic locations in which customer funds may be held, and the required qualifications for permissible depositories in those locations.

.58 Some areas of recent focus in regard to these regulations include the treatment of customer-owned securities that are denominated in non-U.S. currencies, and that are held in depositories outside of the U.S.

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1 “Accountants should be aware that in order to conduct a proper audit under these rules, they must be familiar with the Act and the rules and regulations of the commission. In particular, accountants must be familiar with the segregation requirements, the recordkeeping requirements, and the minimum financial regulations applicable to FCMs. Accountants must assure themselves that the daily computations of the segregation requirements are being made in accordance with such requirements. In addition, accountants must ascertain that the periodic computations of the minimum capital requirements are being done in accordance with §1.17 and are being computed monthly in accordance with §1.18. The commission anticipates that it will selectively review the FCM audits conducted by independent public accountants to monitor compliance with the auditing standard set for in §1.16.” 43 F.R. 39956 (September 8, 1978)
All FCMs should take steps to ensure that such depositories satisfy all of the required criteria set forth in Regulation 1.49(d)(3). FCMs should also ensure that such customer-owned securities are included in the segregation computation for the currency in which they are denominated.

Furthermore, FCMs should ensure that offsets to customer account deficits that are denominated in multiple currencies are computed in accordance with Rule 1.49(e). At the close of each business day, Rule 1.49(e) requires the FCM to maintain in segregated accounts sufficient U.S. dollars, held in the United States, to meet all U.S. dollar obligations, and also sufficient funds in each other currency to meet obligations in such currency, with certain permitted substitutions:

- U.S. dollars held in the United States may be used to meet obligations denominated in any other currency, and
- “Money center” currencies and U.S. dollars held in money center countries may be held to meet obligations denominated in currencies other than the U.S. dollar

Foreign Currency Exchange Transactions

CFTC staff issued an advisory on August 30, 2007, concerning retail off-exchange foreign currency futures or option (forex) transactions. The advisory addresses the following issues: (1) registration requirements for associated persons of firms registered as IBs, commodity trading advisors, and commodity pool operators (CPOs) that are involved in forex transactions; (2) the permissibility of certain unregistered affiliates of an FCM to act as proper counterparties in forex transactions; (3) claims that forex customer funds are segregated; (4) introducing entities acting as FCMs; (5) the applicability of the IB guarantee agreement to forex transactions and prohibiting guaranteed IBs from introducing forex transactions to an FCM that is not its guarantor FCM; (6) prohibition of forex account statements of an FCM’s unregistered affiliate being included in the FCM’s account statements to its customers; and (7) prohibition of retail customers acting as counterparties to each other in forex transactions.

In addition, on May 7, 2007, the CFTC and the North American Securities Administrators Association issued a joint investor alert, which remains relevant, to warn of the dangers facing retail investors who are lured into forex trading frauds. The CFTC also has published on its Web site other information related to fraudulent activity involving off-exchange retail forex transactions.

CFTC Annual “Dear CPO” Letter

On January 16, 2008, CFTC staff issued its annual letter to CPOs outlining key reporting issues and common reporting deficiencies found in annual financial reports for commodity pools. The letter emphasized the CFTC staff’s concerns and, accordingly, may alert the auditor to high-risk issues that could affect assertions contained in the financial statements of commodity pools. CFTC staff suggested that CPOs share the letter with their independent auditors. CFTC staff anticipates issuing a similar letter in January 2009.

The letter addresses the following concerns:

- Due Dates Of Commodity Pool Financial Filings—Late Filings
- Complex Entities
- Requests for Limited Relief From U.S. GAAP Compliance for Certain Offshore Commodity Pools
- Initial Annual Reports and Final Annual Reports
- Other Filings by CPOs Regarding:
  - Replacement of an accountant, Election of fiscal year, and
  - Regulation 4.13 Exemptions
- Accounting Developments:
— FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, implementation and its impact on participants’ redemptions;
— Alternative Investments, Audit Considerations
— AICPA Technical Guidance Regarding Offering Costs
— FASB Statement No. 157

• Recent Regulatory Developments Affecting CPOs


.64 The CFTC’s Division of Clearing and Intermediary Oversight has issued similar letters in prior years, which are available at the commission’s Web site. Those letters should be consulted with respect to commodity pool annual financial statements and reporting. Specifically relevant and still applicable information available in such prior letters includes

• reports for pools for the fiscal year in which an initial claim of exemption under Regulation 4.13 is filed (2006 CPO letter).
• notice regarding election of fiscal year other than calendar year (2006 CPO letter).
• requests for confidential treatment of commodity pool annual reports (2006 CPO letter).
• AICPA SOP 95-2 applicability to both required audited and unaudited commodity pool annual financial reports (2004 CPO letter).

.65 In addition, CFTC interpretations and other staff letters that provide written guidance concerning the Act and the commission’s regulations are available on the commission’s Web site. In particular, CFTC Interpretative Letter 94-3, *Special Allocations of Investment Partnership Equity*, addresses how a CPO should report a special allocation of partnership equity to the general partner or any other special class of participant of an investment partnership in the financial statements of a commodity pool.

National Futures Association

.66 The National Futures Association (NFA) amended several of its rules governing Forex Dealer Members (FDMs). The Reauthorization Act increases the adjusted net capital requirement for certain forex counterparty FCMs and Retail Foreign Exchange Dealers to $20 million. This increase is to be phased in, with the first increase scheduled to have taken effect 120 days after the enactment or at such later date as the CFTC proposes and finalizes rules regarding retail forex transactions. The CFTC has not, as of this writing, published final rules effectuating the capital requirement and other provisions of the Reauthorization Act. Given that congress recognized the importance of increased capital requirements, however, NFA adopted rules raising the minimum net capital requirement for its FDMs to $20 million to meet the increased requirements set forth in the Reauthorization Act. NFA’s rules phase-in the minimum capital requirement pursuant to the following schedule: $10 million on October 31, 2008; $15 million on January 17, 2009; and $20 million on May 16, 2009.

.67 In addition to the increase in the required minimum capital, NFA Financial Requirements Section 12 regarding the collection of security deposits was revised. Section 12(a) requires that FDMs collect and
maintain minimum security deposits of either 1 percent or 4 percent of the notional value of each forex transaction, depending on the currency. Section 12(b) provides an exemption from this requirement for those members who consistently maintained at least twice the required adjusted net capital. The rule was revised to provide that a FDM that consistently maintains 150 percent of the required adjusted net capital would be exempt from having to collect the prescribed security deposits.

**Regulatory Update—Financial Industry Regulatory Authority**

**Auction Rate Securities**

.68 Due to the current financial market’s turmoil, it is important for auditors to keep abreast of the issues and guidance related to auction rate securities (ARS). Certain information is covered in the following paragraphs; however, auditors should keep current on the issues and related guidance due to changing conditions. Issues related to ARS have been addressed by Financial Industry Regulatory Authority (FINRA) in a number of publications of note during 2008. On March 6, 2008, Regulatory Notice 08-08, FINRA Temporarily Increases Margin Maintenance Requirements on Auction Rate Securities Backed by Fixed Income Products, was issued and temporarily increased the maintenance margin requirements, pursuant to NYSE Rule 431(a)(10) and NASD Rule 2520, on all ARSs that are backed by fixed income products, irrespective of whether or not such securities are deemed to be investment grade. Effective on the date of issuance, the maintenance margin requirement increased to 25 percent.

.69 The notice reminded member firms that auction rate preferred securities (ARPS) issued by closed end funds are not margin eligible under Regulation T, and therefore 100 percent margin maintenance is required on those securities. In addition, the notice reminded member firms that certain NYSE, NASD, and SEC rules require that the amount of any deficiency between the equity in the account and the margin required should be deducted in computing the net capital of the member firm. See Regulatory Notice 08-08 at www.finra.org/Industry/Regulation/Notices/2008/P038096 for more detail.

.70 During April 2008 two related interpretation letters were issued. The April 11, 2008, letter states that, as agreed to by SEC staff, member firms would not be required to apply a charge to their net capital for any margin deficiencies resulting from nonpurpose credit extended on ARPS, or to exclude from the customer reserve formula computation those related nonpurpose loans to customers, provided that the firms met the conditions specified in the letter. The second interpretative letter, dated April 24, 2008, revised the original letter due to firms’ difficulties in meeting one of the original requirements because of market conditions.

.71 Subsequent to the April interpretation letters and based upon recent developments, Regulatory Notice 08-65, Auction Rate Securities, dated November 2008, granted additional relief to those brokers and dealers that have agreed to implement buyback programs for ARSs. This relief is related to the net capital, reserve formula, nonpurpose loan, and maintenance margin requirements applicable to credit extended on ARSs. The relief will be available to member firms only with respect to the accounts of retail customers whose account assets do not exceed $10 million and to any accounts of charitable organizations. In addition, certain conditions must be satisfied with respect to liquidity loans collateralized by ARSs to qualify for the relief.

.72 FINRA also published an investor alert, Auction Rate Securities: When Auctions Fail, which explains what ARSs are and what alternatives are available to investors in anticipation of illiquidity or in response to failed auctions. This publication is available at http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P038207.

**Money Market Mutual Funds**

.73 FINRA issued temporary measures related to certain money market mutual funds that have frozen customer redemptions or whose net asset value has declined below $1.00 per share. Effective October 21, 2008, Regulatory Notice 08-60, Money Market Mutual Funds, announced temporary margin maintenance, net
capital, and reserve formula requirements. The notice is available at the FINRA Web site at www.finra.org/Industry/Regulation/Notices/2008/P117276.

Other FINRA News

.74 FINRA continues to work toward a new consolidated rulebook, which not only consolidates the existing rules, but also considers the evolving nature of the securities industry and the diversity of firms subject to FINRA regulation. To assist with this transition, FINRA has created a Rule Conversion Chart to show how new FINRA rules are related to the NASD and incorporated NYSE rules that they will replace. This information is available on the FINRA Web site at www.finra.org/Industry/Regulation/FINRARules/p085668.

.75 On August 13, 2008, FINRA and NYSE Regulation, Inc., announced an agreement with 10 U.S. exchanges to strengthen surveillance, investigation, and enforcement to prevent insider trading. The agreement assigns responsibility for the detection of insider trading, regardless of where in the country the trading occurs, as follows:

• FINRA is responsible for AMEX- and NASDAQ-listed securities.
• NYSE Regulation is responsible for NYSE and NYSE Arca-listed securities.

.76 This agreement consolidates the individual insider trading programs at each exchange within FINRA and NYSE Regulation. As a result of this new structure, insider traders will likely be more readily identified.

Regulatory Update—Financial Crimes Enforcement Network

.77 Financial Crimes Enforcement Network (FinCEN) issued interpretive guidance on September 10, 2008, to clarify whether a person who conducts transactions in currency or other commodities is a “money services business” for purposes of complying with the Bank Secrecy Act and its regulations. This guidance specifically addresses whether a broker or dealer in currency or other commodities is a “money transmitter” when, in the ordinary course of business, the broker or dealer accepts and transmits funds in order to effect transactions in currency or other commodities for or with a customer. Whether a person is a “money transmitter” and whether a “money transmitter” is required to register with FinCEN is a matter of facts and circumstances. For more information, see FIN-2008-G008, Application of the Definition of Money Transmitter to Brokers and Dealers in Currency and Other Commodities. This and other guidance is available on the FinCEN Web site at www.fincen.gov/statutes_regs/guidance.

Audit and Attestation Issues and Developments

Audit Risks Arising From Current Economic Conditions

.78 As discussed previously, we have experienced unprecedented events in the economy and financial markets in 2008 into 2009. These events will undoubtedly affect the audits you are performing. Recent economic conditions may cause additional risk factors that had not existed or did not have a material effect on audit clients in prior years. When obtaining an understanding of the external factors that affect the entity and the risks associated with those factors, the auditor may consider whether conditions exist that indicate risks of material misstatement. Some examples that relate to current economic conditions are as follows:

• Operations that are exposed to volatile markets, which may include oil, agriculture, or currency markets
• Operations in regions with economic volatility, including employment and housing issues
• Constraints on the availability of capital and credit
• Use of off-balance-sheet financings, special-purpose entities, and other complex financing arrangements
- Volatile real estate markets and the credit crisis, which result in significant measurement uncertainty, including accounting estimates and fair value measurements
- ARS—impairment and accounting for settlements
- Accounting for warrants under TARP’s CPP
- Accounting for credit derivatives
- Asset impairment and other than temporary impairment
- Marginal achievement of explicitly stated strategic objectives
- Disclosures (subsequent events and risks and uncertainties)
- Going concern issues
- Liquidity and net capital issues
- Guarantees that may be triggered due to economic conditions
- Adequacy of corporate governance and the oversight of internal controls
- Risks that fraud may occur due to economic pressures

.79 This list is not all inclusive. However, the list of issues that an auditor should consider will likely change frequently in the coming months. It is imperative that the auditor keep abreast of current economic and industry developments and hot topics so that all relevant items are considered in the assessment of risk.

.80 Though many of these risks are not new to business, consideration of the many ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks. This section of the alert discusses a number of audit issues for you to consider given the current economic environment.

### Auditing Auction Rate Securities

.81 The ARS market experienced significant challenges in early 2008, and the demand for that type of investment decreased significantly. The situation provides two challenges for auditors. First, the question of impairment arises. The issue of asset impairment is discussed in paragraph .91. The second issue relates to the accounting for ARS settlements, especially as it relates to settlement agreements. Several large financial institutions entered into settlement agreements with regulators during 2008 regarding the marketing and selling of ARS. For a given entity, the accounting for ARS depends on whether an actual settlement agreement has been signed, and whether that agreement applies to their acquisition of the position.

.82 Prior to a settlement agreement being signed, an auditor should consider whether a contingent liability exists that would require recognition and disclosure as per FASB Statement No. 5, *Accounting for Contingencies*. If it is probable that a contingent loss has been incurred, and if that loss is reasonably estimable, the liability should be accrued and recognized as a charge to current period income. If it is reasonably possible that a contingent loss has been incurred, or if the loss is not reasonably estimable, the nature of the contingency and an estimate of the possible loss (or the range of such loss) should be disclosed.

.83 Once a settlement agreement is signed, any liability is no longer a contingent liability, and the accounting pursuant to FASB Interpretation (FIN) No. 45, *Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34*, should be followed.
Auditing Fair Value Measurements

**PCAOB Staff Audit Practice Alert No. 2**

.84 In December 2007, the PCAOB issued Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400 par. .02). This guidance is intended to remind auditors of their responsibilities under existing PCAOB standards and was divided into four sections, summarized as follows.

*Fair Value Measurements*

.85 PCAOB Staff Audit Practice Alert No. 2 notes that the auditor should obtain an understanding of the company’s process for determining fair value measurements and disclosures, including relevant controls, and should, among other things,

- evaluate whether management’s assumptions are reasonable and either reflect, or are not consistent with, market information.
- consider the extent to which management’s reliance on historical financial information in developing an assumption is justified.
- evaluate whether the company’s method for determining fair value measurements is applied consistently, and also whether such consistency is appropriate in light of the changing environment or changing circumstances affecting the company.

.86 The auditor should also consider the increased risk of management bias and of material misstatement if valuation inputs are not observable.

*Classification Within the FASB Statement No. 157 Valuation Hierarchy*

.87 PCAOB Staff Audit Practice Alert No. 2 notes that, because different consequences are associated with each of the three levels of the hierarchy, auditors should be alert for circumstances in which the company may have an incentive to inappropriately classify fair value measurements within the hierarchy. As examples of incentives, it notes that lower-level classifications permit greater use of management judgment in valuation, and that level 3 measurements require more extensive disclosures than other levels.

*Using the Work of Specialists*

.88 PCAOB Staff Audit Practice Alert No. 2 also reminds auditors that they should evaluate whether they have the necessary skill and knowledge to perform audit procedures related to fair value measurement, considering such factors as significant use of unobservable inputs, complexity of valuation techniques, and the materiality of the measurements. It also reminds auditors of their responsibilities when using the work of a specialist, whether engaged by the issuer or the auditor.

*Use of a Pricing Service*

.89 PCAOB Staff Audit Practice Alert No. 2 states that, if a company uses a pricing service, the auditor should determine the nature of the information the pricing service provides (for example, quoted prices from an active market, observable inputs, or model-based measurements), and adjust audit procedures accordingly. If measurements are based on a model, the auditor should obtain an understanding of the model and evaluate the reasonableness of assumptions. It also reminds the auditor to consider whether the prices provided by the service meet the “principal market” or “most advantageous market” criteria of FASB Statement No. 157.
Asset Impairment and Other Than Temporary Impairment

Asset valuations that are not reported at fair value merit close consideration in the current economic and market environment. Goodwill, intangibles, and fixed assets are examples of items that warrant evaluation. An item that may be affected significantly for a broker-dealer is an exchange membership. Although these particular items are highlighted here, the auditor needs to consider the issue of impairment, including other than temporary impairment, in all aspects of the audit.

Liquidity Considerations

AICPA staff has issued a new nonauthoritative Technical Practice Aid (TPA) Technical Question and Answer (TIS), “Liquidity Restrictions” (AICPA, Technical Practice Aids, TIS sec. 1100.15), addressing the potential accounting and auditing implications when a fund or its trustee imposes restrictions on a nongovernemental entity’s ability to withdraw its balance in a money market fund or other short-term investment vehicle. The TPA covers balance sheet classification, disclosures, debt covenants, subsequent events, and going concern considerations, among other things. The TPA can be found at www.aicpa.org/download/acctstd/TIS1100_15.pdf.

Alternative Investments

Another source of information for auditors is the AICPA’s practice aid Alternative Investments—Audit Considerations. This nonauthoritative practice aid focuses on the existence and valuation assertions associated with alternative investments, but also discusses general considerations pertaining to auditing alternative investments, management representations, disclosure of certain significant risks and uncertainties, and reporting. As defined in the foreword of the practice aid, alternative investments are “investments for which a readily determinable fair value does not exist...including private investment funds meeting the definition of an investment company...such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as bank common/collective trust funds.” The full text of this practice aid can be located on the AICPA’s Web site at www.aicpa.org/download/members/div/auditstd/Alternative_Investments_Practice_Aid.pdf.

Consideration of an Entity’s Ability to Continue as a Going Concern

The consideration of an entity’s ability to continue as a going concern is required in every audit performed under generally accepted auditing standards (GAAS), and it is an especially important consideration in the current state of the financial markets and the overall economy. The time frame for this consideration is one year beyond the date of the financial statements. If the auditor believes substantial doubt exists about the entity’s ability to continue as a going concern, the next steps are to obtain management’s plans to mitigate the effect of such conditions and then assess the likelihood these plans can be effectively implemented.

The following may indicate substantial doubt about the ability of the entity to continue as a going concern:

- Negative trends such as negative cash flows from operating activities, recurring operating losses or working capital deficiencies, or lack of the ability to obtain additional financing
- Other indications of financial difficulties such as defaults on debt or debt covenants, arrearages in dividends; the need to seek new sources of financing; denial of surety credit or usual trade credit; or the disposal of substantial assets
- Inadequate capitalization
- Internal matters such as turnover in key management positions like CEO, CFO, controller, and project manager, or substantial dependence on the success of a particular investment
• External matters such as loss of key customers or business relationships, or significant counterparty failures
• Entrance into a new market for which the entity might not have the required expertise to successfully compete (for example, new investment strategy or new geographic areas)
• External matters such as legalities or market conditions

.96 If an auditor determines substantial doubt exists about an entity’s ability to continue as a going concern, the auditor should communicate with those charged with governance of the entity in accordance with AU section 341, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern (AICPA, Professional Standards, vol. 1). AU section 341 provides guidance to an auditor with respect to evaluating whether substantial doubt exists about an entity’s ability to continue as a going concern and what the auditor should do if uncertainty exists about the entity’s viability.

Disclosures

.97 Increased emphasis is being given to disclosures in the current environment. The “SEC Developments” and the “On the Horizon” sections of this alert discuss disclosures and new guidance being developed. The area of subsequent events is one that warrants increased attention. AU section 560, Subsequent Events (AICPA, Professional Standards, vol. 1), provides guidance regarding the reporting of subsequent events, including both events present on the balance sheet date and events that occur subsequent to that date.

.98 SOP 94-6, Disclosure of Certain Significant Risks and Uncertainties (AICPA, Technical Practice Aids, ACC sec. 10,640), starts by stating, “The volatile business and economic environment underscores a need for improved disclosures about the significant risks and uncertainties that face reporting entities.” Although this guidance was written more than 10 years ago, it is certainly pertinent today. The disclosures in SOP 94-6 focus primarily on risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term and the near-term functioning of the reporting entity. The risks and uncertainties can stem from the nature of the entity’s operations, from the necessary use of estimates in the preparation of the entity’s financial statements, and from significant concentrations in certain aspects of the entity’s operations.

Consideration of Fraud

.99 Auditors should consider the pressures an entity is facing when planning and performing the audit engagement. Auditors have a responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud. Paragraph .32 of AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), explains that when obtaining information about the entity and its environment, an auditor should consider whether the information indicates that one or more fraud risk factors are present. The auditor should use professional judgment in determining whether a risk factor is present and should be considered in identifying and assessing the risks of material misstatement due to fraud. Paragraph .33 of AU section 316 lists three conditions generally present when fraud exists: incentive or pressure to perpetrate fraud, an opportunity to carry out the fraud, and attitude or rationalization to justify the fraudulent action.

.100 A recent fraud discussed in the news, which contains all three conditions just mentioned, has been that of Bernard Madoff Investment Securities. At the time of this writing, the owner of the investment firm, Bernard Madoff, has been charged with paying off earlier investors with money from new investors. This is a classic example of a Ponzi scheme, which demonstrated itself as markets began declining and many investors requested redemptions of their capital. The losses from this fraud are estimated at $50 billion. While the details of this fraud are just beginning to be investigated, auditors should ensure they are properly testing for existence of assets, such as investments in this scenario.

.101 PCAOB Staff Audit Practice Alert No. 3, Audit Considerations in the Current Economic Environment (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 400 par. 03), also contains a
discussion of the risk of fraud and how to respond to that risk. This PCAOB alert is available at www.pcaobus.org/Standards/Staff_Questions_and_Answers/2008/12-05_APB_3.pdf.

**Summary of Recent Auditing and Attestation Pronouncements and Related Guidance**

.102 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. This alert is intended to be used in conjunction with the Comprehensive Audit Risk Alert—2008 (product no. 022339kk); therefore, only industry specific pronouncements and related guidance or those of specific significance to the industry are summarized herein. For information on auditing and attestation standards issued subsequent to the writing of this alert, please refer to the AICPA Accounting and Auditing Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the CPA Letter, Journal of Accountancy, and in the quarterly electronic newsletter In Our Opinion, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

.103 The PCAOB establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review Audit Risk Alert SEC and PCAOB Developments—2008 (product no. 022499kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by visiting www.cpa2biz.com.

<table>
<thead>
<tr>
<th>Recent Auditing and Attestation Pronouncements and Related Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Statement on Auditing Standards (SAS)</strong></td>
</tr>
<tr>
<td>No. 115, Communicating Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, vol. 1, AU sec. 325)</td>
</tr>
<tr>
<td>Issue Date: October 2008</td>
</tr>
<tr>
<td>(Applicable to audits conducted in accordance with GAAS)</td>
</tr>
<tr>
<td><strong>SAS No. 114, The Auditor’s Communication With Those Charged With Governance</strong></td>
</tr>
<tr>
<td>(AICPA, Professional Standards, vol. 1, AU sec. 380)</td>
</tr>
<tr>
<td>Issue Date: December 2006</td>
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<tr>
<td>(Applicable to audits conducted in accordance with GAAS)</td>
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</tbody>
</table>

(continued)
### Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Auditing Standards</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SAS No. 113, Omnibus Statement on Auditing Standards—2006 (AICPA, Professional Standards, vol. 1)</strong>&lt;br&gt;Issue Date: November 2006</td>
<td>This statement does the following:&lt;br&gt;• Revises the terminology used in the 10 standards of AU section 150, Generally Accepted Auditing Standards, to reflect terminology in AU section 120, Defining Professional Requirements in Statements on Auditing Standards (AICPA, Professional Standards, vol. 1).&lt;br&gt;• Adds a footnote to the headings before paragraphs .35 and .46 in AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), to provide a clear link between the auditor’s consideration of fraud and the auditor’s assessment of risk and the auditor’s procedures in response to those assessed risks.&lt;br&gt;• Replaces throughout the SASs the term completion of fieldwork with the term date of the auditor’s report.&lt;br&gt;• Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor’s report.</td>
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<tr>
<td><strong>SAS Nos. 104–111, the risk assessment standards</strong>&lt;br&gt;Issue Date: March 2006</td>
<td>The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits; focusing on identifying and assessing the risks of material misstatements; further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels; and improving the linkage between the risks, controls, audit procedures, and conclusions. These eight SASs became effective for audits of financial statements for periods beginning on or after December 15, 2006.</td>
</tr>
<tr>
<td><strong>Statement on Standards for Attestation Engagements (SSAE) No. 15, An Examination of an Entity’s Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements (AICPA, Professional Standards, vol. 1, AT sec. 501)</strong>&lt;br&gt;Issue Date: October 2008</td>
<td>This statement establishes requirements and provides guidance that applies when a practitioner is engaged to perform an examination of the design and operating effectiveness of an entity’s internal control over financial reporting (examination of internal control) that is integrated with an audit of financial statements (integrated audit). This SSAE is effective for integrated audits for periods ending on or after December 15, 2008. Earlier implementation is permitted.</td>
</tr>
<tr>
<td><strong>SSAE No. 14, SSAE Hierarchy (AICPA, Professional Standards, vol. 1, AT sec. 50)</strong>&lt;br&gt;Issue Date: November 2006</td>
<td>This statement identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in AT section 20, Defining Professional Requirements in Statements on Standards for Attestation Engagements (AICPA, Professional Standards, vol. 1). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.</td>
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</table>
# Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Interpretation No.</th>
<th>Description</th>
<th>Issue Date</th>
<th>Revised Date</th>
<th>Interpretive publication</th>
</tr>
</thead>
<tbody>
<tr>
<td>SOP 07-2</td>
<td>Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisers, or Other Service Providers (AICPA, Technical Practice Aids, AUD sec. 14,430)</td>
<td>October 2007</td>
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Statement of Position (SOP) 07-2 primarily addresses examination engagements in which a practitioner reports on the suitability of the design and operating effectiveness of a service provider’s controls in achieving specified compliance control objectives. Examples of the service providers addressed by this SOP are investment advisers, custodians, transfer agents, administrators, and principal underwriters that provide services to investment companies, investment advisers, or other service providers.
<table>
<thead>
<tr>
<th>Recent Auditing and Attestation Pronouncements and Related Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>AICPA Technical Practice Aid (TPA)</strong></td>
</tr>
<tr>
<td><strong>Technical Questions and Answers (TIS)</strong></td>
</tr>
<tr>
<td>section 1100.15, “Liquidity Restrictions” (AICPA, <em>Technical Practice Aids</em>)</td>
</tr>
<tr>
<td>Issue Date: October 2008 (Nonauthoritative)</td>
</tr>
<tr>
<td><strong>TIS sections 8200.05–.16. (AICPA, <em>Technical Practice Aids</em>)</strong></td>
</tr>
<tr>
<td>Issue Date: April and May 2008 (Nonauthoritative)</td>
</tr>
<tr>
<td><strong>TIS section 9120.08, “Part of an Audit Performed in Accordance With International Standards on Auditing” (AICPA, <em>Technical Practice Aids</em>)</strong></td>
</tr>
<tr>
<td>Issue Date: April 2008 (Nonauthoritative)</td>
</tr>
<tr>
<td><strong>TIS section 9100.06, “The Effect of Obtaining the Management Representation Letter on Dating the Auditor’s Report” (AICPA, <em>Technical Practice Aids</em>)</strong></td>
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<tr>
<td>Issue Date: May 2007 (Nonauthoritative)</td>
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<table>
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<tr>
<th>Topic</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>TIS section 8350.01, “Current Year Audit Documentation Contained in the Permanent File” (AICPA, Technical Practice Aids)</td>
<td>This question and answer discusses whether the provisions of AU section 339, Audit Documentation (AICPA, Professional Standards, vol. 1), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that AU section 339 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year’s audit report.</td>
</tr>
<tr>
<td>AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, Audit Confirmations (AICPA, Technical Practice Aids, PA sec. 16,240)</td>
<td>This practice alert is a response to practitioners’ current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics.</td>
</tr>
<tr>
<td>AICPA PITF PA 07-1, Dating of the Auditor’s Report and Related Practical Guidance (AICPA, Technical Practice Aids, PA sec. 16,290)</td>
<td>This practice alert provides guidance regarding application of certain provisions of AU section 339, primarily related to dating the auditor’s report.</td>
</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 6, Evaluating Consistency of Financial Statements (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)</td>
<td>This standard and its related amendments update the auditor’s responsibilities to evaluate and report on the consistency of a company’s financial statements and align the auditor’s responsibilities with FASB Statement No. 154, Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3. This standard also improves the auditor reporting requirements by clarifying that the auditor’s report should indicate whether an adjustment to previously issued financial statements results from a change in accounting principles or the correction of a misstatement. Auditing Standard No. 6 became effective November 15, 2008.</td>
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<tr>
<td>PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”)</td>
<td>This standard replaces the PCAOB’s previous internal control standard, Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements. This principles-based auditing standard is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company’s financial statements, and, at the same time, eliminate procedures that are unnecessary. Auditing Standard No. 5 is required to be used by registered audit firms for all audits of internal control over financial reporting no later than for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted and encouraged.</td>
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</tbody>
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(continued)
**Recent Auditing and Attestation Pronouncements and Related Guidance**

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<thead>
<tr>
<th>PCAOB Staff Audit Practice Alert No. 3, Audit Considerations in the Current Economic Environment (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 400 par. 03)</th>
<th>This practice alert is designed to assist auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis. The practice alert addresses six main areas: overall audit considerations; auditing fair value measurements; auditing accounting estimates; auditing the adequacy of disclosures; auditor’s consideration of a company’s ability to continue as a going concern; and additional audit considerations for selected financial reporting areas.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue Date: December 2008</td>
<td><strong>PCAOB Rule 3526, Communication with Audit Committees Concerning Independence (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”)</strong></td>
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<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
<td>Rule 3526 requires the registered public accounting firm to</td>
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<td>• describe in writing to the audit committee of the issuer all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client who, as of the date of the communication, may reasonably be thought to bear on independence,</td>
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<td>• discuss with the audit committee of the issuer the potential effects of any relationships that could impact independence, should they be appointed as the issuer’s auditor, and</td>
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<td>• document the substance of these discussions. These discussions should occur at least annually.</td>
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<td>Issue Date: August 2008</td>
<td>The board also adjusted the implementation schedule for Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”) as it applies to tax services. The board agreed not to apply Rule 3523 to tax services provided on or before December 31, 2008, when those services are provided during the audit period and are completed before the professional engagement period begins. The amendments to Rule 3523 became effective August 28, 2008. The remaining provisions of Rule 3526 became effective on September 30, 2008.</td>
</tr>
<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
<td><strong>PCAOB Rule 3525, Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”)</strong></td>
</tr>
<tr>
<td>Issue Date: July 2007</td>
<td>This rule requires a registered public accounting firm that seeks preapproval of an issuer audit client’s audit committee to perform internal control-related nonaudit services that are not otherwise prohibited by the act or the rules of the Securities and Exchange Commission (SEC) or the PCAOB to describe, in writing, to the audit committee the scope of the proposed service, discuss with the audit committee the potential effects of the proposed service on the firm’s independence, and document the substance of the firm’s discussion with the audit committee. These requirements parallel the auditor’s responsibility in seeking audit committee preapproval to perform tax services for an audit client under PCAOB Rule 3524, Audit Committee Pre-approval of Certain Tax Services (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”). This rule is effective for audits of fiscal years ending on or after November 15, 2007.</td>
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<tr>
<td><strong>Recent Auditing and Attestation Pronouncements and Related Guidance</strong></td>
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<tr>
<td><strong>PCAOB Conforming Amendments to the Interim Auditing Standards</strong></td>
<td></td>
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<tr>
<td><strong>Issue Date:</strong> September 16, 2008</td>
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<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
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<tr>
<td><strong>PCAOB Conforming Amendments to the Interim Auditing Standards</strong></td>
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<tr>
<td><strong>Issue Date:</strong> July 2007</td>
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<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
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<td>In conjunction with the PCAOB’s adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in appendix 3 of PCAOB Release No. 2007-005A at <a href="http://www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf">www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf</a>. These amendments are effective for audits of fiscal years ending on or after November 15, 2007, the same effective date of Auditing Standard No. 5.</td>
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<tr>
<td><strong>PCAOB Release No. 2007-001, Observations on Auditors’ Implementation of PCAOB Standards Relating to Auditors’ Responsibilities With Respect to Fraud</strong></td>
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<tr>
<td>(AICPA, <em>PCAOB Standards and Related Rules</em>, “Selected SEC-Approved PCAOB Releases”)</td>
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<tr>
<td><strong>Issue Date:</strong> January 2007</td>
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<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
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<tr>
<td>This release focuses on aspects of the PCAOB’s interim auditing standards that address the auditor’s responsibility with respect to fraud, specifically AU section 316, <em>Consideration of Fraud in a Financial Statement Audit</em> (AICPA, <em>PCAOB Standards and Related Rules</em>, PCAOB Standards, As Amended). This report does not change or propose to change any existing standard nor is the PCAOB providing any new interpretation of existing standards.</td>
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<tr>
<td><strong>PCAOB Staff Questions and Answers, Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees</strong></td>
<td></td>
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<tr>
<td>(AICPA, <em>PCAOB Standards and Related Rules</em>, PCAOB Staff Guidance, sec. 100 par. .05)</td>
<td></td>
</tr>
<tr>
<td><strong>Issue Date:</strong> April 2007</td>
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<tr>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
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<td>Topics covered include the following:</td>
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<td>• The application of PCAOB Rule 3522(a), <em>Tax Transactions</em> (AICPA, <em>PCAOB Standards and Related Rules</em>, Rules of the Board, “Rules”), when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm</td>
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<td>• Whether a public accounting firm can advise an audit client on the tax consequences of structuring a particular transaction</td>
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<td>• Whether a registered public accounting firm’s independence is affected by the IRS’s subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in PCAOB Rule 3522(b)</td>
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<tr>
<td>• Clarification that the auditor must evaluate whether a person is in a financial reporting oversight role at affiliates and not just the audit client itself</td>
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<td>• Clarification of the term <em>other change in employment event</em> as it relates to PCAOB Rule 3522(c)</td>
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</table>
Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>PCAOB Staff Audit Practice Alert No. 2, Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 400 par. .02)</th>
<th>This practice alert highlights certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of GAAP that are particularly relevant to the current economic environment.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue Date: December 2007</td>
<td>(Applicable to audits conducted in accordance with PCAOB standards)</td>
</tr>
</tbody>
</table>

Accounting Issues and Developments

Accounting for Warrants Under TARP

.104 As mentioned previously in this alert, the TARP CPP was issued in 2008 as part of the EESA. Under this program, the U.S. Treasury will acquire senior preferred stock and associated warrants in exchange for injecting capital into the qualifying financial institution. More information regarding this program is available on the U.S. Treasury Web site at www.ustreas.gov/initiatives/eesa/.

.105 After the announcement of this plan, practitioners started to consider the accounting implications of these warrants. In general, depending on the terms of warrants, some are accounted for as liabilities as they represent a future obligation. If these warrants were accounted for as liabilities, the intended benefits may be somewhat diminished due to the warrants being accounted for at fair value, thereby possibly increasing earnings volatility and part of the capital proceeds being allocated to the warrants, which resides in the liability section of the balance sheet as opposed to in the equity section.

.106 To address this concern, the SEC and FASB issued a letter on October 24, 2008, that noted, “we would not object if the Warrants...were to be classified as permanent equity under applicable U.S. GAAP [Generally Accepted Accounting Principles], provided that the issuer of such Warrants has sufficient authorized but unissued shares of the class of stock that may be required upon settlement and any other necessary shareholder approvals have been obtained.” The letter went on to state that as long as these approvals were obtained prior to the end of the fiscal quarter in which the warrants were issued, immediate classification as permanent equity would be appropriate as well. Further, the letter explains that if an issuer does not have the required shareholder approval, including shareholder approval for sufficient authorized but unissued shares of the class of stock that may be required for settlement, the previously mentioned treatment would be appropriate provided that the issuer takes the necessary action to secure sufficient approvals prior to the end of the fiscal quarter in which the warrants are issued.

Fair Value Accounting

.107 FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. In February 2008, FASB issued FASB Staff Position (FSP) FAS 157-2, Effective Date of FASB Statement No. 157, which was effective upon issuance. The FSP delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008 and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow FASB and its constituents the time to consider the various implementation issues associated with FASB Statement No. 157.
Results of the SEC Study on Fair Value Accounting

.108 The EESA, signed into law on October 3, 2008, contains a provision that required the SEC to conduct a study on mark-to-market (fair value) accounting that was to be completed within 90 days. The act mandated that six key issues be addressed by the study:

1. The effects of such accounting standards on a financial institution’s balance sheet
2. The impacts of such accounting on bank failures in 2008
3. The impact of such standards on the quality of financial information available to investors
4. The process used by FASB in developing accounting standards
5. The advisability and feasibility of modifications to such standards
6. Alternative accounting standards to those provided in FASB Statement No. 157

.109 In late December 2008, the SEC released to Congress its EESA-mandated report on fair value accounting standards. This report recommends against the suspension of fair value accounting standards. However, it does recommend improvements to existing practice, including reconsidering the accounting for impairments and the development of additional guidance for determining fair value of investments in inactive markets, including situations where market prices are not readily available.

.110 The highlights of the report include the following findings related to the key EESA mandated topics and eight recommendations by the SEC staff:

a. In regard to the effect of fair value accounting standards on financial institutions’ balance sheets, the SEC staff observed that fair value measurements were used to measure a minority of the assets and liabilities included in financial institutions’ balance sheets. However, these fair value measurements did significantly affect financial institutions’ reported income.

b. In regard to the impact of fair value accounting on bank failures in 2008, the staff observed that it did not appear to play a significant role.

c. In regard to the impact of fair value accounting on the quality of financial information available to investors, the staff noted investors generally support measurements at fair value. However, many investors also indicated the need for improvements to existing fair value standards.

d. The report confirmed that FASB, as an independent accounting standard-setter, is best positioned to develop neutral accounting guidance. However, steps could be taken to enhance the existing process in terms of timeliness and transparency.

e. The staff found that suspending FASB Statement No. 157 would lead to a reversion of practice and would likely increase investor uncertainty. Nonetheless, the issuance of additional guidance is advised.

f. The staff provided recommendations on the advisability and feasibility of modifications to existing accounting standards and related financial report requirements.

.111 The eight key recommendations from the report are as follows:

• FASB Statement No. 157 should be improved, but not suspended.
• Existing fair value and mark-to-market requirements should not be suspended.
• Additional measures should be taken to improve the application and practice related to existing fair value requirements (particularly as they relate to both level 2 and level 3 estimates).
• Accounting for financial asset impairments should be readdressed.
• Further guidance should be implemented to foster the use of sound judgment.
Accounting standards should continue to be established to meet the needs of investors.

Formal measures to address the operation of existing accounting standards in practice should be established.

Accounting for investments in financial assets should be simplified.

.112 The changes in fair value accounting standards and the FASB standard setting process that could occur due to the results of this report will be seen in the coming months and years. The full text of the Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting can be accessed at the SEC Web site at www.sec.gov/news/studies/2008/marktomarket123008.pdf.

Measurements of Fair Value in Illiquid Markets

.113 In the current economic environment significant issues exist related to fair value measurement in illiquid or inactive markets. To provide guidance regarding these issues, the SEC and FASB issued a joint document, SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting (SEC and FASB Press Release) on September 30, 2008, that contains clarifications on fair value accounting in the current marketplace. This guidance can be found at www.sec.gov/news/press/2008/2008-234.htm.

.114 Given the state of the market, confusion exists regarding the use of market quotes and whether current market prices represent fair value in accordance with FASB Statement No. 157 or are in actuality distressed sales. In October, 2008, FASB issued FSP FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active, which clarifies FASB Statements No. 157’s application in an inactive market and also amends the standard to include an illustrative example.

.115 FSP FAS 157-3 noted,

Broker (or pricing service) quotes may be an appropriate input when measuring fair value, but they are not necessarily determinative if an active market does not exist for the financial asset. In weighing a broker quote as an input to a fair value measurement, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence.

.116 Two other factors to consider when considering the reliability of a quote are whether it can be determined that market participants currently are transacting at that price and the appropriateness of the valuation technique employed by the pricing service to arrive at the quoted price.

.117 As discussed in paragraph 7 of FASB Statement No. 157, “an orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).” Low transaction volume involving such assets does not necessarily translate into forced sales, nor does it necessarily mean the market is inactive. The market would still be considered active as long as the frequency and volume of transactions are sufficient to provide reliable pricing information. Additionally, the size of an entity’s position should not be a factor in this determination. To deem a transaction forced or disorderly, persuasive evidence and judgment are required.

.118 If transaction volume is too low to provide accurate pricing information and therefore not a level 1 input, those observable transactions are to be considered level 2 inputs or even level 3 inputs if they are significantly adjusted. In October 2007, the AICPA Center for Audit Quality (CAQ) issued a white paper, Measurements of Fair Value in Illiquid (or Less Liquid) Markets, as noted in CAQ alert #2007-51. This white paper noted that some characteristics of an inactive market are “few transactions for the asset, the prices are not current, price quotations vary substantially, or in which little information is released publicly.” In describing an inactive market as well, the SEC and FASB Press Release noted, “A significant increase in the spread between the amount sellers are ‘asking’ and the price that buyers are ‘bidding,’ or the presence of a relatively
small number of ‘bidding’ parties, are indicators that should be considered in determining whether a market is inactive.”

.119 The lack of an active market and the information obtained from it require further analysis. According to FSP FAS 157-3, “[I]n cases where the volume and level of trading activity in the asset have declined significantly, the available prices vary significantly over time or among market participants, or the prices are not current, the observable inputs might not be relevant and could require significant adjustment.” Further, the SEC and FASB Press Release noted, “in some cases using unobservable inputs (level 3) might be more appropriate than using observable inputs (level 2); for example, when significant adjustments are required to observable inputs it may be appropriate to utilize an estimate based primarily on unobservable inputs.”

.120 When significant adjustments are made to an observable input (level 2), it becomes a level 3 fair value measurement. The level of activity in the market in which transactions occur (that is, whether the market is active or inactive) is an indicator of the extent to which the entity will have relevant observable market data that will not require a significant adjustment in its determination of fair value.

.121 Paragraph C85 of FASB Statement No. 157 states that “the reporting entity may use its own data to develop unobservable inputs, provided that there is no information reasonably available without undue cost and effort that indicates that market participants would use different assumptions in pricing the asset or liability.” A reporting entity is prohibited from ignoring observable transaction or assumptions that are reasonably available without undue cost and effort.

.122 The FSP concluded, “the use of a reporting entity’s own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available.” Similarly, the SEC and FASB press release noted, “In some cases, multiple inputs from different sources may collectively provide the best evidence of fair value. In these cases expected cash flows would be considered alongside other relevant information. The weighting of the inputs in the fair value estimate will depend on the extent to which they provide information about the value of an asset or liability and are relevant in developing a reasonable estimate.”

.123 Readers are encouraged to review the full text of the FSP and the amended standard (inclusive of its recently added illustrative example) on the FASB Web site at www.fasb.org. The FSP was effective upon issuance, including any prior periods for which financial statements have not been issued. Any revisions from changes in valuation techniques or their application shall be accounted for as a change in accounting estimate in accordance with FASB Statement No. 154, Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3; however, the disclosure provisions of FASB Statement No. 154 for such revisions are not required.

Valuation Resource Group

.124 FASB has established the Valuation Resource Group (VRG), which provides FASB staff with information on the existing implementation issues surrounding fair value measurements used for financial statement reporting purposes and the alternative viewpoints associated with those implementation issues. Any authoritative decisions are subject to FASB’s normal, open due process. A summary of the VRG’s discussions is available on FASB’s Web site at http://72.3.243.42/project/valuation_resource_group.shtml.

Derivative Instruments and Hedging Activities

Credit Derivatives

.125 Credit derivatives are an investment vehicle that has received quite a bit of press recently, mainly as related to credit default swaps. This investment presents challenges because they are not generally exchange traded or settled and because, by definition, credit derivatives rely on the value of other events or instruments and significant judgment about current and future conditions. The valuation of these
instruments involves assumptions that are highly subjective. In addition, when evaluating credit derivatives, counterparty default risk is an important factor to consider. Due to the issues around credit derivatives, the SEC chairman has asked the U.S. Congress to provide the statutory authority necessary for government oversight of the credit default swap market. Regulators are taking steps to set up a central clearinghouse for the credit derivatives market to assist in this oversight. Readers should remain alert to further developments.

**Derivative Disclosures**

.126 In March 2008, FASB issued FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity’s financial position, financial performance, and cash flows.

.127 The standard improves transparency about the location and amounts of derivative instruments in an entity’s financial statements; how derivative instruments and related hedged items are accounted for under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*; and how derivative instruments and related hedged items affect the entity’s financial position, financial performance, and cash flows.

.128 FASB Statement No. 161 achieves these improvements by requiring disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also provides more information about an entity’s liquidity by requiring disclosure of derivative features that are credit risk–related. Finally, it requires cross-referencing within footnotes to enable financial statement users to locate important information about derivative instruments.

.129 It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. FASB has since, in FSP FAS 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161*, clarified the effectiveness provisions to include annual financial statements including the final interim period of the year. The FSP is intended to improve disclosures about credit derivatives by requiring more information about the potential adverse effects of changes in credit risk on the financial position, financial performance, and cash flows of the sellers of credit derivatives.

**Other Recently Issued Guidance**

**FSP FAS 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions**

.130 In February 2008, FASB issued FSP FAS 140-3, which was intended to address questions about the accounting for a repurchase agreement relating to a previously transferred financial asset. Specifically, it addresses whether circumstances existed that would permit a transferor and transferee to evaluate the accounting for a transfer of a financial asset separately from a repurchase financing under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, when the counterparties to the two transactions are the same. The FSP presumes that an initial transfer and repurchase financing are part of the same arrangement and provides certain criteria which, if met, allow the two transactions to be evaluated separately under FASB Statement No. 140. Among the criteria are the following:

- The two transactions have a valid and distinct business purpose for being entered into separately.
- The initial transfer and repurchase financing are not contractually contingent upon one another, and the pricing and performance of either transaction is not dependent on the terms and execution of the other.
The repurchase financing provides the initial transferor with recourse to the initial transferee upon default, not solely to the market risk of the transferred asset.

The financial asset subject to the transactions is readily obtainable in the marketplace, and the transactions are executed at market rates.

The maturity of the repurchase financing must be before the maturity of the financial asset.

.131 The FSP is effective for financial statements issued for fiscal years beginning after November 15, 2008, and interim periods within those years. Refer to the FASB Web site for the full text of this FSP.

**FSP APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)**

.132 FSP APB 14-1 was issued on May 9, 2008. This staff position clarifies that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of Accounting Principles Board Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants. This guidance also specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity’s nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. Additionally, this guidance nullifies or amends a number of EITF Issues. The full text of FSP APB 14-1 is available on the FASB Web site at www.fasb.org.

**FSP FAS 140-4 and FIN 46(R)-8, Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities**

.133 FASB issued FSP FAS 140-4 and FIN 46(R)-8 in December 2008. The document increases disclosure requirements for public companies for reporting periods that end after December 15, 2008.

.134 The purpose of this FSP is to promptly improve disclosures by public entities and enterprises until the pending amendments to FASB Statement No. 140 and FIN 46(R), Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51, are finalized and approved by the board. Effective at the end of the first reporting period (interim and annual) after issuance of the FSP for public entities, the FSP amends FASB Statement No. 140 to require public entities to provide additional disclosures about transfers of financial assets and variable interests in qualifying special-purpose entities. It also amends FIN 46(R) to require public enterprises to provide additional disclosures about their involvement with variable interest entities.

.135 See the FASB Web site for complete information.

**Convergence With International Financial Reporting Standards**

.136 Since the signing of the Norwalk Agreement by FASB and International Accounting Standards Board (IASB) the bodies have had a common goal—one set of accounting standards for international use. In this agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. In 2005 meetings, FASB and the IASB reaffirmed their commitment to the convergence of U.S. GAAP and IFRS. A common set of high quality, globally accepted standards remains the long-term strategic priority of both FASB and the IASB.

.137 FASB and the IASB have undertaken several joint projects being conducted simultaneously to further the goal of convergence of U.S. GAAP and IFRS. These ongoing joint projects address the conceptual framework, business combinations, financial statement presentation, and revenue recognition. For more information on the status of this project go to www.fasb.org and www.iasb.org.
SEC Eases Acceptance of IFRS Financial Statements

.138 On December 21, 2007, the SEC took a major step towards easing the acceptance of IFRS financial statements by adopting rules to accept from foreign private issuers financial statements prepared in accordance with IFRS as issued by the IASB without reconciliation to U.S. GAAP. This rule marks an important step in the process toward the development of a single set of high quality, globally accepted accounting standards. This rule became effective March 4, 2008. Readers can access this rule at www.sec.gov/rules/final/2007/33-8879.pdf.

.139 More than 100 countries now either require or allow the use of IFRS for the preparation of financial statements by listed companies, and additional countries are moving to do the same. This recent movement to IFRS outside the United States has resulted in an increase of filings with the SEC of foreign private issuers that represent in the footnotes to their financial statements that their financial statements comply with IFRS as published by the IASB—from a relative few in 2005 to approximately 110 in 2006. The SEC expects this number will continue to increase in the future, particularly pursuant to Canada’s announced move to IFRS, as there currently are approximately 500 foreign private issuers from Canada.

.140 This movement to IFRS also has begun to affect U.S. issuers, in particular those with a significant global footprint. For instance, certain U.S. issuers may compete for capital globally in industry sectors in which a critical mass of non-U.S. companies report under IFRS. Also, U.S. issuers with subsidiaries located in jurisdictions that have moved to IFRS may prepare those subsidiaries’ financial statements in IFRS for purposes of local regulatory or statutory filings. Readers should remain alert to developments regarding convergence.

IFRS Roadmap

.141 On August 27, 2008, the SEC voted to publish for public comment a proposed roadmap (which was released on November 14, 2008) that could lead to the use of IFRS by U.S. issuers beginning in 2014. The SEC would make a decision in 2011 on whether adoption of IFRS is in the public interest and would benefit investors. The proposed multiyear plan sets out several milestones that, if achieved, could lead to the use of IFRS by U.S. issuers in their filings with the SEC.

.142 The top 20 companies in each industry, as determined by market capitalization, could elect to begin filing IFRS financial statements for fiscal periods ending after December 15, 2009. If, in 2011, the SEC adopts IFRS for all filers, the roadmap suggests mandatory filing for large accelerated filers beginning in 2014, accelerated filers in 2015, and nonaccelerated filers in 2016. The 90-day comment period ends on February 19, 2009.

.143 The proposed roadmap sets forth seven milestones that will influence the SEC’s decision to adopt IFRS for all filers. These milestones relate to: improvements in accounting standards, the accountability and funding of the International Accounting Standards Committee Foundation, the improvement in the ability to use interactive data for IFRS reporting, education and training relating to IFRS, limited early use of IFRS where this would enhance comparability for U.S. investors, the anticipated timing of future rulemaking by the SEC, and the implementation of the mandatory use of IFRS by U.S. issuers.

.144 Additionally, the roadmap proposes two alternatives for U.S. issuers that elect to use IFRS to disclose U.S. GAAP information. Proposal A suggests a U.S. issuer that elects to file IFRS financial statements would provide the reconciling information from U.S. GAAP to IFRS called for under IFRS 1, First-time Adoption of International Financial Reporting Standards, in a footnote to its audited financial statements. This information would include the restatement of and reconciliation from prior year’s financial statements and the related disclosures.

.145 Proposal B suggests that U.S. issuers that elect to file IFRS financial statements would provide the reconciling information from U.S. GAAP to IFRS required under IFRS 1. They would also disclose on an annual basis certain unaudited supplemental U.S. GAAP financial information covering a three-year
period. This unaudited supplemental financial information would be in the form of a reconciliation from IFRS to U.S. GAAP.

.146 The roadmap does not address how the SEC would mandate IFRS; however, an option noted would be “for the FASB to continue to be the designated standard setter for purposes of establishing the financial reporting standards in issuer filings with the Commission. In this option our presumption would be that the FASB would incorporate all provisions under IFRS, and all future changes to IFRS, directly into GAAP as used in the United States. This type of approach has been adopted by a significant number of other jurisdictions when they adopted IFRS as the basis of financial reporting in their capital markets.”


.148 Readers of this alert should note that the proposed roadmap does not apply to investment companies under the Investment Company Act of 1940, nor to other types of financial reports filed with or furnished to the SEC by regulated entities, such as registered brokers and dealers.

**AICPA Launches IFRS.com Web Site**

.149 The AICPA is calling for an orderly transition and reasonable time frame of three to five years for the U.S. accounting profession to adopt IFRS. During a FASB forum on June 16, 2008, held to facilitate an open dialogue about whether and how to move the U.S. financial reporting system to IFRS and define next steps in that process, it was noted that awareness of IFRS is growing, but most believe it will take three to five years to prepare.

.150 To assist in both awareness building and education the AICPA launched a new Web site, www.ifrs.com, in May 2008. The site provides current information about developments in international convergence. The growing acceptance of IFRS as a basis for U.S. financial reporting represents a fundamental change for the U.S. accounting profession. Acceptance of a single set of high-quality accounting standards for worldwide use by public companies has been gaining momentum around the globe for the past few years.

.151 Developed by the AICPA, in partnership with its marketing and technology subsidiary, CPA2Biz, IFRS.com provides a comprehensive set of resources for accounting professionals, auditors, financial managers, audit committees, and other users of financial statements.

.152 The Web site features tools and resources to help CPAs get acquainted with IFRS, the surrounding issues, and available support. Resources include a history of convergence, a high-level overview of the differences between IFRS and U.S. GAAP, frequently asked questions, articles, textbooks, CPE courses and live conference training, helpful links, and assistance for audit committee members.

**FASB Accounting Standards Codification™**

.153 On January 15, 2008, FASB launched the verification period of FASB Accounting Standards Codification™ (ASC). FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing all authoritative literature in a topically organized structure. FASB ASC includes all accounting standards issued by a standard setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, AICPA, Emerging Issues Task Force (EITF), and related literature. FASB ASC also includes relevant authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance.

.154 The purpose of FASB ASC is not to change GAAP, but rather to reorganize thousands of GAAP pronouncements into approximately 90 topics. At the end of the extended verification period, FASB is expected to formally approve FASB ASC as the single source of authoritative U.S. accounting and reporting standards, other than guidance issued by the SEC. On July 1, 2009, FASB will supersede all then-existing
non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the codification will become nonauthoritative. FASB ASC can be accessed at http://asc.fasb.org/home.

.155 Constituents are encouraged to use FASB’s online FASB ASC Research System free of charge and provide feedback to FASB on the codification.

.156 The AICPA has published the Financial Reporting Alert FASB Codification Developments—2008 (product no. 029209kk). This Financial Reporting Alert is intended to provide a better understanding of FASB ASC, outline its structure, as well as provide case studies on navigating FASB ASC Research System and performing accounting research.

Summary of Recent Accounting Pronouncements and Related Guidance

.157 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. This alert is intended to be used in conjunction with the Comprehensive Audit Risk Alert—2008 (product no. 022339kk); therefore, only industry specific pronouncements and related guidance or those of specific significance to the industry are summarized herein. For information on accounting standards issued subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the CPA Letter and Journal of Accountancy.

<table>
<thead>
<tr>
<th>Recent Accounting Pronouncements and Related Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>FASB Statement No. 162 (May 2008)</td>
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<tr>
<td>FASB Statement No. 161 (March 2008)</td>
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<tr>
<td>FASB Statement No. 160 (December 2007)</td>
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<td>FASB Statement No. 141 (revised 2007) (December 2007)</td>
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<tr>
<td>FASB Statement No. 158 (September 2006)</td>
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</tbody>
</table>
### Recent Accounting Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th><strong>FASB Interpretation No. (FIN) 48 (June 2006)</strong></th>
<th><strong>Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FSP FIN 48-2, Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises, issued in February 2008, defers the effective date of FIN 48 for certain nonpublic enterprises, as defined in the FSP, to the annual financial statements for fiscal years beginning after December 15, 2007.</strong></td>
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| **FASB Emerging Issues Task Force (EITF) Issues (Various dates)** | **Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF Issues.** |

| **FASB Staff Positions (Various dates)** | **Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.** |

<table>
<thead>
<tr>
<th><strong>AICPA SOP 07-1 (AICPA, Technical Practice Aids, ACC sec. 10,930)</strong></th>
<th><strong>Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>In February 2008, FASB issued FSP SOP 07-1-1, Effective Date of AICPA Statement of Position 07-1, which indefinitely defers the effective date of SOP 07-1. Entities that early adopted SOP 07-1 before December 15, 2007 are permitted, but not required, to continue to apply the provisions of the SOP. No other entities may adopt the provision of the SOP, subject to the exception in the following sentence: if a parent entity that early adopted the SOP chooses not to rescind its early adoption, an entity consolidated by the parent entity that is formed or acquired after that parent entity’s adoption of the SOP must apply the provisions of the SOP in its stand-alone financial statements.</strong></td>
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<tr>
<th><strong>TIS section 6300.36 (AICPA, Technical Practice Aids) (Nonauthoritative)</strong></th>
<th><strong>This question and answer discusses when an insurance company may change its original policyholder benefit liability assumptions.</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>TIS section 9150.25 (AICPA, Technical Practice Aids) (Nonauthoritative)</strong></td>
<td><strong>This question and answer discusses considerations when an accountant’s work efforts result in or contribute to the existence of financial statements.</strong></td>
</tr>
<tr>
<td><strong>TIS section 1100.15 (AICPA, Technical Practice Aids) (Nonauthoritative)</strong></td>
<td><strong>This question and answer discusses auditing and accounting issues related to withdrawal restrictions placed on short-term investments by a money market fund or its trustee.</strong></td>
</tr>
<tr>
<td><strong>TIS sections 6910.25–.28 (AICPA, Technical Practice Aids) (Nonauthoritative)</strong></td>
<td><strong>These questions and answers discuss financial statement presentation considerations for investment companies.</strong></td>
</tr>
<tr>
<td><strong>TIS sections 6140.20–.22 (AICPA, Technical Practice Aids) (Nonauthoritative)</strong></td>
<td><strong>These questions and answers discuss not-for-profit organizations fund-raising expenses.</strong></td>
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Recent Accounting Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>TIS section 6931.08–.10 (AICPA, Technical Practice Aids)</th>
<th>These questions and answers discuss various employee benefit plan topics.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Nonauthoritative)</td>
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</tr>
<tr>
<td>AICPA Practice Guide</td>
<td>Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48</td>
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<td>(Nonauthoritative)</td>
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.158 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance to the securities industry have been briefly explained in this alert. The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. The Comprehensive Audit Risk Alert—2008 and other AICPA industry-specific alerts also contain summaries of recent pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or visit www.cpa2biz.com.

Recent AICPA Independence and Ethics Pronouncements

.159 Audit Risk Alert Independence and Ethics Developments—2008 (product no. 022479kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

On the Horizon

.160 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to the securities industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards. The following table lists the various standard setting bodies’ Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.

<table>
<thead>
<tr>
<th>Standard-Setting Body</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>AICPA Auditing Standards Board (ASB)</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/</a></td>
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<tr>
<td>Financial Accounting Standards Board (FASB)</td>
<td><a href="http://www.fasb.org">www.fasb.org</a></td>
</tr>
<tr>
<td>Professional Ethics Executive Committee (PEEC)</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/">www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/</a></td>
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<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
<td><a href="http://www.pcaob.org">www.pcaob.org</a></td>
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Auditing Pipeline—Nonissuers

ASB Clarity Project

.161 In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the next two or three years, the ASB will be redrafting all of the existing auditing sections contained in the Codification of Statements on Auditing Standards (AU sections of the AICPA’s Professional Standards) to apply the clarity drafting conventions and to converge with the International Standards on Auditing issued by the International Auditing and Assurance Standards Board.

.162 The ASB proposes that, except to address current issues, all redrafted standards will become effective at the same time. Only those standards needing to address current issues would have earlier effective dates. The ASB believes that a single effective date will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted standards are finalized to allow sufficient time for training and updating of firm audit methodologies. Currently, the date is expected to be for audits of financial statements for periods beginning no earlier than December 15, 2010. This date depends on satisfactory progress being made, and will be amended should that prove necessary. See the Clarity Project Explanatory Memorandum and the discussion paper Improving the Clarity of ASB Standards at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm.

Auditing Pipeline—Issuers

.163 In October 2008, the PCAOB proposed seven new auditing standards to update and supersede the current risk assessment standards, which will be available for comment through February 18, 2009. The PCAOB chairman noted the proposals demonstrate the view that the risk of fraud is a central part of the audit process and not a separate consideration. The proposed standards integrate the risk assessment standards with the standard for the audit of internal control over financial reporting. Many of the International Auditing and Assurance Standards Board’s risk assessment standards were utilized in creating these proposed standards and efforts were made to reduce any unnecessary differences.

.164 These proposed standards each have a statement of objective for the auditor, which were loosely adapted from the International Auditing Standards. This is an example of the move in the United States from rules-based to principles-based accounting and auditing standards as these objectives do not state required outcomes. The seven proposed standards are as follows:

- Audit Risk in an Audit of Financial Statements
- Audit Planning and Supervision
- Identifying and Assessing Risks of Material Misstatement
- The Auditor’s Responses to the Risks of Material Misstatement
- Evaluating Audit Results
- Consideration of Materiality in Planning and Performing an Audit
- Audit Evidence

.165 As with any new auditing standard or amendment to a PCAOB standard, after adoption by the PCAOB the standards will be submitted to the SEC for approval.

.166 Guidance issued by the PCAOB is included in the section of this alert titled “Summary of Recent Auditing and Attestation Pronouncements and Related Guidance.” For more information regarding recent developments at both the SEC and PCAOB, readers may refer to Audit Risk Alert SEC and PCAOB Developments—2008 (product no. 022499kk).
Accounting Pipeline

.167 A number of accounting projects and pronouncements are currently in progress. Those specifically related to the securities industry or those related to recent industry conditions are briefly summarized in the following paragraphs. For a summary of additional significant accounting projects and pronouncements, refer to the Comprehensive Audit Risk Alert—2008 (product no. 022339kk). Such in progress issues include the following:

- Accounting for hedging activities exposure draft
- Accounting for contingencies exposure draft
- Phase 2 of the fair value project
- Transfers of financial assets project
- Earnings per share convergence project
- Income tax convergence project
- Leases project
- Reporting discontinued operations project
- Going concern proposed statement
- Subsequent events proposed statement
- Amendments to FIN 46(R) proposed statement

This alert includes discussion of some of these projects in the following sections.

Going Concern

.168 In October 2008, FASB issued an exposure draft of a proposed statement on going concern. The comment deadline was December 8, 2008. Currently, as discussed in the “Audit and Attestation Issues and Developments” section, the guidance on going concern is covered in AU section 341 and not in accounting literature. As discussed in the exposure draft, “The Board believes that accounting guidance about the going concern assumption should be directed specifically to management of a reporting entity because management is responsible for preparing an entity’s financial statements and evaluating its ability to continue as a going concern.”

.169 This proposed statement would require management to consider all available information about the future when assessing whether a going concern assumption is appropriate. The time horizon for this consideration is defined as at least, but not limited to, 12 months from the end of the reporting period, rather than the current limit of one year beyond the date of the financial statements. The proposal also requires disclosures when substantial doubt exists as to an entity’s ability to continue as a going concern. The AICPA formally commented on this exposure draft and that comment letter can be read at www.fasb.org/ocl/1650-100/53021.pdf. Readers are also encouraged to review the exposure draft of this standard on the FASB Web site.

Subsequent Events

.170 On October 9, 2008, FASB also issued a proposed statement, Subsequent Events. This proposed statement establishes general accounting and disclosure standards for events that occur subsequent to the balance sheet date but before financial statements are issued or available to be issued. It would also require disclosure of the date through which management has evaluated subsequent events. The comment period ended in December.
Transfers and Servicing of Financial Assets and Liabilities

.171 FASB is working on a project to amend FASB Statement No. 140 to simplify the guidance on accounting for transfers of financial assets to improve consistency and transparency in financial reporting. This project is being performed largely in conjunction with the separate project on the reconsideration of FIN 46(R). The combined effect of the amended guidance would result in a restriction of the use of off-balance sheet accounting for securitized debt.

.172 On September 15, 2008, FASB issued two proposed statements. The first, revised exposure draft Accounting for Transfers of Financial Assets—an Amendment of FASB Statement No. 140, would remove the concept of a qualifying special purpose entity (QSPE) and remove the exceptions from applying FIN 46(R) to QSPEs. In addition, FASB Statement No. 140 would be amended to revise and clarify the derecognition requirements for transfers of financial assets and the initial measurement of beneficial interests that are received as proceeds by a transferor in connection with transfers of financial assets. Enhanced disclosure requirements are also included.

.173 In conjunction with the proposed statement discussed in the previous paragraph, FASB issued a second proposed statement, Amendments to FASB Interpretation No. 46(R), which proposes stricter guidelines that would require additional assessments to determine which entity receives the benefits from the assets and would therefore include them in its financial statements.

.174 Both of these proposed statements would be effective as of the beginning of each reporting entity’s first fiscal year beginning after November 15, 2009. Earlier application would be prohibited.

Proposed FSP ARB 43-a

.175 The proposed FSP ARB 43-a, Amendment of the Inventory Provisions of Chapter 4 of ARB No. 43, was issued on May 1, 2008. This proposed staff position would require that inventories included in an entity’s trading activities be initially and subsequently valued at fair value with changes in fair value being recognized in earnings. The comment period ended June 16, 2008, and the final FSP is expected to be issued in the first quarter of 2009. For more information visit www.fasb.org/project/trading_inventory.shtml.

Proposed FASB Emerging Issues Task Force Issues and Staff Positions

.176 Proposed FASB EITF Issues. Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

.177 Proposed FSPs. A number of additional proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

Resource Central

.178 The following are various resources that practitioners engaged in the securities industry may find beneficial.

Publications

.179 Practitioners may find the following publications useful. Choose the format best for you—online, print, or CD-ROM.

- Audit and Accounting Guide Brokers and Dealers in Securities (2008) (product no. 012708kk [paperback], WBR-XXkk [online with associated Audit Risk Alert], or DBR-XXkk [CD-ROM with the associated Audit Risk Alert])
- Audit Guide Analytical Procedures (2008) (product no. 012558kk [paperback], WAN-XXkk [online], or DAN-XXkk [CD-ROM])

AICPA Audit and Accounting Manual AAM §8110.179
• Audit Guide Assessing and Responding to Audit Risk in a Financial Statement Audit (2006) (product no. 012456kk [paperback] or WRA-XXkk [online])
• Audit Guide Auditing Derivative Instruments, Hedging Activities, and Investments in Securities (2008) (product no. 012528kk [paperback], WDI-XXkk [online], or DDI-XXkk [CD-ROM])
• Audit Guide Audit Sampling (2008) (product no. 012538kk [paperback], WAS-XXkk [online], or DAS-XXkk [CD-ROM])
• Audit Guide Service Organizations: Applying SAS No. 70, as Amended (2008) (product no. 012778kk [paperback], WSV-XXkk [online], or DSV-XXkk [CD-ROM])
• Comprehensive Audit Risk Alert—2008 (product no. 022339kk [paperback], WGE-XXkk [online], or DGE-XXkk [CD-ROM])
• Audit Risk Alert Independence and Ethics Developments—2008 (product no. 022479kk [paperback], WIA-XXkk [online], or DIA-XXkk [CD-ROM])
• Audit Risk Alert SEC and PCAOB Developments—2008 (product no. 022499kk [paperback])
• Audit Risk Alert Understanding the New Auditing Standards Related to Risk Assessment (product no. 022526kk [paperback])
• Checklists and Illustrative Financial Statements for Corporations (product no. 008939kk [paperback] or WCP-CL [online])
• Audit and Accounting Manual (2008) (product no. 005138kk [paperback], WAM-XXkk [online], or AAM-XXkk [loose leaf])
• Accounting Trends & Techniques, 62nd Edition (product no. 009900kk [paperback] or WAT-XXkk [online])

Additional resources for accountants in business and industry are the Financial Reporting Alert series, designed to be used by members of an entity’s financial management and audit committee to identify and understand current accounting and regulatory developments affecting the entity’s financial reporting.

• Financial Reporting Alert Current Accounting Issues and Risks—2008 (product no. 029208kk)
• Financial Reporting Alert FASB Codification Developments—2008 (product no. 029209kk)

AICPA reSOURCE: Accounting and Auditing Literature

The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm’s needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to the AICPA’s latest Professional Standards, Technical Practice Aids, Audit and Accounting Guides (more than 20), Audit Risk Alerts (more than 15), and Accounting Trends & Techniques. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Continuing Professional Education

The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

• AICPA’s Annual Accounting and Auditing Update Workshop (2008–2009 Edition) (product no. 736184kk [text] or 187192kk [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
• SEC Reporting (product no. 736775kk [text] or 186756kk [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.
• Annual Public Company Update: SEC, PCAOB, and AICPA Developments (product no. 731884kk [text]). Identify recent SEC and PCAOB rules and guidance as well as other developments that affect filings or engagements for this reporting cycle.

• International Versus U.S. Accounting: What in the World is the Difference? (product no. 731666kk [text]). With the fast pace of the convergence project, understanding the differences between IFRS and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRS and U.S. GAAP.

• The International Financial Reporting Standards: An Overview (product no. 157220kk [online] or 739750HSkk [DVD]). This course captures a live presentation on IFRS given to the AICPA Board of Directors.

Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.183 AICPA CPEExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz, is AICPA’s flagship online learning product. AICPA members pay $180 for a new subscription and $149 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPEExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to the securities industry include the following:

− FIN 46R—Variable Interest Entity Consolidation Rules
− SEC Reporting
− SEC/PCAOB Quarterly (and Annual) Updates

To register or learn more, visit www.cpa2biz.com.

Webcasts

.184 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession’s leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.

IFRS Quarterly Webcast Series

.185 The IFRS Quarterly Webcast Series, brought to you each calendar quarter is part of a multistep educational process to get practitioners, financial managers, and auditors up to speed on all aspects of IFRS implementation. Over the course of the quarterly series, IFRS standards will be covered in depth. International harmonization is quickly approaching, and this series will help both accountants and auditors stay abreast of the developments and the changes they will need to implement.

CFO Quarterly Roundtable Series

.186 The CFO Quarterly Roundtable Series, brought to you each calendar quarter via webcast, covers a broad array of “hot topics” that successful organizations employ and subjects that are important to the CFO’s personal success. From financial reporting, budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.
SEC Quarterly Update Series

.187 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession’s leading experts on what is “hot” at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you “plugged in” to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.188 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.189 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA’s Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. Beginning January 14, 2008, hotline hours were extended so that the hotline is now available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/.

Ethics Hotline

.190 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA’s Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

Industry Conference

.191 The National Securities Industry Conference is held in the fall of each year. Cosponsored by the AICPA and the Financial Management Division of SIFMA, this two-day conference is designed to update attendees on recent developments related to the securities industry and includes accounting, auditing, industry, and regulatory developments. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

The CAQ

.192 The CAQ, which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ’s mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession’s core values of integrity, objectivity, honesty, and trust.

.193 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit thecaq.aicpa.org.
AICPA Industry Expert Panel—Stockbrokerage and Investment Banking

.194 For information about the activities of the AICPA Stockbrokerage and Investment Banking Industry Expert Panel, visit the panel’s Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_stockbroker_investbank.htm.

Industry Web Sites

.195 The Internet covers a vast amount of information that may be valuable to auditors of securities industry entities, including current industry trends and developments. Some of the more relevant sites for auditors with securities industry clients include those shown in the following table:

<table>
<thead>
<tr>
<th>Organization</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commodity Futures Trading Commission (CFTC)</td>
<td><a href="http://www.cftc.gov">www.cftc.gov</a></td>
</tr>
<tr>
<td>Financial Crimes Enforcement Network (FinCEN)</td>
<td><a href="http://www.fincen.gov/">www.fincen.gov/</a></td>
</tr>
<tr>
<td>Financial Industry Regulatory Authority (FINRA)</td>
<td><a href="http://www.finra.org/">www.finra.org/</a></td>
</tr>
<tr>
<td>Futures Industry Association</td>
<td><a href="http://www.futuresindustry.org/">www.futuresindustry.org/</a></td>
</tr>
<tr>
<td>National Futures Association</td>
<td><a href="http://www.nfa.futures.org/">www.nfa.futures.org/</a></td>
</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
<td><a href="http://www.pcaob.org">www.pcaob.org</a></td>
</tr>
<tr>
<td>Securities Industry and Financial Markets Association (SIFMA)</td>
<td><a href="http://www.sifma.org/">www.sifma.org/</a></td>
</tr>
</tbody>
</table>

.196 The securities industry practices of some of the larger CPA firms may also contain industry-specific auditing and accounting information that is helpful to auditors.

* * * *

.197 This Audit Risk Alert replaces Securities Industry Developments—2007/08.

.198 The Audit Risk Alert Securities Industry Developments is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year’s Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to sreed@aicpa.org or write to

Susan M. Reed, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110
## Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

<table>
<thead>
<tr>
<th>Web Site Name</th>
<th>Content</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>American Institute of CPAs (AICPA)</td>
<td>Summaries of recent auditing and other professional standards as well as other AICPA activities</td>
<td><a href="http://www.aicpa.org">www.aicpa.org</a>&lt;br&gt;www.cpa2biz.com&lt;br&gt;www.ifrs.com</td>
</tr>
<tr>
<td>AICPA Accounting Standards Executive Committee (AcSEC)</td>
<td>Issues guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards</a></td>
</tr>
<tr>
<td>AICPA Accounting and Review Services Committee (ARSC)</td>
<td>Develops and issues review and compilation standards and interpretations</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/Accounting+and+Review+Services+Committee">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/Accounting+and+Review+Services+Committee</a></td>
</tr>
<tr>
<td>AICPA Professional Issues Task Force (PITF)</td>
<td>Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/Professional+Issues+Task+Force">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/Professional+Issues+Task+Force</a></td>
</tr>
<tr>
<td>Economy.com</td>
<td>Source for analyses, data, forecasts, and information on the U.S. and world economies</td>
<td><a href="http://www.economy.com">www.economy.com</a></td>
</tr>
<tr>
<td>The Federal Reserve Board</td>
<td>Key interest rates</td>
<td><a href="http://www.federalreserve.gov">www.federalreserve.gov</a></td>
</tr>
<tr>
<td>Financial Accounting Standards Board (FASB)</td>
<td>Summaries of recent accounting pronouncements and other FASB activities</td>
<td><a href="http://www.fasb.org">www.fasb.org</a></td>
</tr>
<tr>
<td>USA.gov</td>
<td>Portal through which all government agencies can be accessed</td>
<td><a href="http://www.usa.gov">www.usa.gov</a></td>
</tr>
<tr>
<td>Governmental Accounting Standards Board (GASB)</td>
<td>Summaries of recent accounting pronouncements and other GASB activities</td>
<td><a href="http://www.gasb.org">www.gasb.org</a></td>
</tr>
<tr>
<td>International Accounting Standards Board (IASB)</td>
<td>Summaries of International Financial Reporting Standards and International Accounting Standards</td>
<td><a href="http://www.iasb.org">www.iasb.org</a></td>
</tr>
<tr>
<td><strong>Web Site Name</strong></td>
<td><strong>Content</strong></td>
<td><strong>Web Site</strong></td>
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<tr>
<td>------------------------------------------------------</td>
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<td>---------------</td>
</tr>
<tr>
<td>International Auditing and Assurance Standards Board (IAASB)</td>
<td>Summaries of International Standards on Auditing</td>
<td><a href="http://www.iaasb.org">www.iaasb.org</a></td>
</tr>
<tr>
<td>International Federation of Accountants (IFAC)</td>
<td>Information on standards setting activities in the international arena</td>
<td><a href="http://www.ifac.org">www.ifac.org</a></td>
</tr>
<tr>
<td>Private Company Financial Reporting Committee (PCFRC)</td>
<td>Information on the initiative to further improve FASB’s standard setting process to consider needs of private companies and their constituents of financial reporting</td>
<td><a href="http://www.pcfr.org">www.pcfr.org</a></td>
</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
<td>Information on accounting and auditing activities of the PCAOB and other matters</td>
<td><a href="http://www.pcaob.org">www.pcaob.org</a></td>
</tr>
</tbody>
</table>

[The next page is 8375.]

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**AICPA Audit and Accounting Manual**
AAM Section 8120

Not-for-Profit Entities Industry Developments—2009

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of not-for-profit entities with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also can be used by an entity’s internal management to address areas of audit concern.

This publication is an other auditing publication as defined in AU section 150, Generally Accepted Auditing Standards (AICPA, Professional Standards, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Christopher Cole
Technical Manager
Accounting and Auditing Publications

Acknowledgments

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James Remis
John Ring
Nancy Shelmon
Susan Stewart

How This Alert Helps You

01 This Audit Risk Alert (alert) helps you plan and perform your audits of not-for-profit entities (NFPs). This alert can also be used by an entity’s internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may result in the material misstatement of financial statements and delivers information
about emerging practice issues and current accounting, auditing, and regulatory developments. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.02 Certain accounting guidance referenced in this alert has been codified into the Financial Accounting Standards Board (FASB) Accounting Standards Codification™ (ASC). FASB is expected to issue FASB ASC as authoritative effective July 1, 2009, at which time it will become the source of authoritative U.S. accounting and reporting standards, in addition to guidance issued by the Securities and Exchange Commission (SEC), for nongovernmental entities. FASB ASC will supersede all then-existing, non-SEC accounting and reporting standards for nongovernmental entities. Once effective, all other nongrandfathered, non-SEC accounting literature not included in FASB ASC will become nonauthoritative. See the discussion of FASB ASC in the “Accounting Issues and Developments” section of this alert.

Audit Risk

.03 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. In AU section 312, Audit Risk and Materiality in Conducting an Audit (AICPA, Professional Standards, vol. 1), audit risk is broadly defined as the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of the risk (both inherent risk and control risk) that the relevant assertions related to balances, classes, or disclosures contain misstatements (whether caused by error or fraud) that could be material to the financial statements when aggregated with misstatements in other relevant assertions related to balances, classes, or disclosures and the risk (detection risk) that the auditor will not detect such misstatements.

.04 The auditor’s combined assessment of inherent risk and control risk is described as the risks of material misstatement. The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the risk assessment to determine the nature, timing, and extent of further audit procedures to be performed.

.05 As set forth in paragraph .12 of AU section 312, the auditor may reduce audit risk by determining overall responses and designing the nature, timing, and extent of further audit procedures. Furthermore, paragraph .19 of AU section 312 explains that the auditor should seek to reduce audit risk at the individual balance, class, or disclosure level in such a way that will enable the auditor to express an opinion on the financial statements as a whole at an appropriately low level of audit risk.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.06 AU section 314, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (AICPA, Professional Standards, vol. 1), establishes requirements and provides guidance about implementing the second standard of field work, as follows: “The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.” Obtaining this understanding is further complicated by the rapidly changing economic environment. In accordance with paragraph .04 of AU section 314, the auditor’s primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures.

.07 The auditor’s understanding of the entity and its environment consists of an understanding of the following:

- Industry, regulatory, and other external factors
Nature of the entity

Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements

Measurement and review of the entity’s financial performance

Internal control, which includes the selection and application of accounting policies

.08 Appendix A of AU section 314 contains examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to the categories previously discussed. Understanding the effects of the current economic climate on each specific audit client is a key step in designing the audit plan.

.09 Business risks result from conditions, events, circumstances, actions, or inactions that could adversely affect the entity’s ability to achieve its objectives and execute its strategies. The setting of inappropriate objectives and strategies also results in business risks. Just as the external environment changes, the handling of the entity’s business also is dynamic, and the entity’s strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement; however, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements; however, not all business risks give rise to risks of material misstatement.

.10 Additionally, NFPs may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces). Additionally, NFPs exist for a variety of exempt purposes, serve a variety of customers, and operate under a vast array of business models. As a result of the diversity within the NFP community, it is critical that the auditor gain an understanding of the specific entity to be audited and the risks inherent to that entity. After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions (including net asset classifications), account balances, and disclosures based on that understanding. Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client’s environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic and Industry Developments

The Current Economic Crisis

.11 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on an entity’s financial statements.

.12 Currently, the U.S. economy continues to experience severe instability. The National Bureau of Economic Research officially declared that, as of December 2007, the United States slid into a recession. The length of the recession and whether the United States will enter into a depression are yet to be determined. Some key occurrences that exhibit the gravity of the economic crisis include the following:

- Federal government intervention in the private sector has increased. Numerous financial institutions and automakers have received bailouts from the government.
- Millions of households owe more on their mortgages than their homes are currently worth. The number of residential home foreclosures continues to increase.
- The number of jobless claims continues to increase.

AICPA Audit and Accounting Manual

AAM §8120.12
U.S. real gross domestic product (GDP), the broadest measure of economic activity, continues to decrease at an increasing rate.

The financial markets continue to experience instability—historic lows followed by rallies. In March 2009, both the S&P 500 and the Dow Jones Industrial Average reached their 12-year lows, and the NASDAQ closed at its lowest point since October 2002.

The Federal Reserve has continued to decrease the federal funds interest rate.

The demand for U.S. Treasury bills has increased at a staggering rate, which drove the interest rate for these Treasury bills to less than 1 percent in March 2009.

The Treasuries-Over-Euro-Dollar Spread reached 4.63 percent in October 2008, a historic high, before returning to 1.04 percent in March 2009.

These key economic indicators further illustrate the severity of the recessionary period that the United States is experiencing.

Key Economic Indicators

The GDP measures output of goods and services by labor and property within the United States. It increases as the economy grows or decreases as it slows. According to advance estimates of the Bureau of Economic Analysis, real GDP decreased at an annual rate of 6.1 percent in the first quarter of 2009. This data indicates a continuation of the slowing of the economy seen in the fourth quarter of 2008, which experienced a decrease of 6.3 percent.

The unemployment rate continues to rise steadily. In April 2009, the unemployment rate was 8.9 percent, representing approximately 13.7 million people. Over the past year, since April 2008, the number of unemployed persons has increased by about 6.0 million or 3.9 percentage points.

As of March 2009, the Federal Reserve had decreased the target for the federal funds rates more than 5.0 percentage points to less than 0.25 percent. The Federal Reserve noted in its March 18, 2009 press release that “economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period.”

Government Intervention to Curtail the Economic Crisis

The U.S. government has taken unprecedented actions to prevent worsening economic conditions, including passing the American Recovery and Reinvestment Act (ARRA) in February 2009, and the Emergency Economic Stabilization Act of 2008 (EESA), facilitating the sale of ailing banks and dramatically increasing the monetary programs available from the Federal Reserve. The results of these actions have not been fully realized to date.

The American Recovery and Reinvestment Act of 2009

In February 2009, President Obama signed legislation designed to work hand in hand with the EESA to stimulate the U.S. economy. The ARRA is designed primarily to combat the rising unemployment trends, put more money in the hands of consumers, and reduce the likelihood that state and local governments will need to raise taxes significantly. According to the White House press release, the legislation will do the following:

- Create or save 3.5 million jobs in the next 2 years
- Provide direct tax relief to working and middle class families
- Double the U.S. renewable energy generating capacity over 3 years
- Stimulate private investment in renewable energy through tax credits and loan guarantees
- Invest $150 billion in U.S. infrastructure projects
• Provide funds to U.S. state and local governments to support health and education programs

.19 Many of the provisions of this legislation took effect immediately in an effort to stimulate consumer spending and boost the economy. The total cost of the spending in the ARRA is $787 billion, which is in addition to the $700 billion in the EESA. Many economists are concerned that further financial support may be necessary before an economic recovery is possible. Additionally, the federal government developed the Web site www.recovery.gov to facilitate a transparent process to ensure accountability for the execution of the package.

Other Government Intervention

.20 The EESA, which was signed into law in October 2008, states in Section 2 of the bill, it “provide[s] authority to the Treasury Secretary to restore liquidity and stability to the U.S. financial system and to ensure the economic well-being of Americans.” Primary components of the EESA bill include the following:

• An allocation of $700 billion to stabilize the U.S. financial system
• The creation of an oversight board, executive compensation rules, and other corporate governance rules for any entities that receive government aid
• An increase of the statutory limit on public debt from $10.0 trillion to $11.3 trillion
• A temporary increase of Federal Deposit Insurance Corporation insurance limits
• The creation of a tax modification for Fannie Mae and Freddie Mac stock losses
• The restatement of the SEC’s authority to suspend the application of FASB Statement No. 157, Fair Value Measurements, which is codified at FASB ASC 820, Fair Value Measurements and Disclosures
• The requirement of the SEC to conduct a study on the impact and effects of FASB Statement No. 157

.21 The EESA authorized the U.S. Treasury to create the Troubled Assets Relief Program (TARP), the original intent of which was to use $700 billion to purchase illiquid mortgage assets from banks. As part of TARP, the Capital Purchase Program (CPP) was intended to inject $250 billion of capital into banks. Half of the CPP funds were distributed to 9 of the largest financial institutions in the nation, which held approximately 55 percent of U.S. banking assets. The other half of the funds were allocated for smaller financial institutions. The clear intent of the CPP was for the participating banks to increase lending; however, many question if the banks have responded accordingly.

.22 In addition to bailout funds targeting financial institutions, a $17.4 billion rescue package for the U.S. automakers was issued in December 2008. The first $13.4 billion was lent to the automakers immediately, and the remaining $4 billion was lent in subsequent months. The U.S. government will continue to work directly with automakers and also will receive nonvoting warrants from automakers that accept taxpayer funding.

.23 The complete effects of the ARRA, as well as the other government interventions, will take time to be felt throughout the economy; however, the primary goal is to increase market confidence and liquidity.

The State of NFPs

.24 The not-for-profit sector continues to play a large role in the world economy. Currently, 1.5 million NFPs are registered with the IRS. Contributions to these entities in 2007 exceeded $306 billion, whereas total revenues in the sector approached $2 trillion, and assets topped $4.1 trillion as of December 2008. According to U.S. Department of Labor (DOL) statistics, 27 percent of the population, or 62 million people in the United States, did volunteer work for NFPs.

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The Philanthropic Giving Index (PGI), established by the Center on Philanthropy at Indiana University, measures trends and expectations in United States charitable giving. The index showed a 27 percent decline during 2008, which reflects the economic turbulence during that period.

NFPs face daunting challenges during this economic downturn. Although contributions to NFPs are decreasing, demand for the services they provide is increasing. The value of endowments, which some entities rely on for support, may have decreased substantially, in some cases, to a point below historic cost, thereby reducing or eliminating much needed funding. As a result, some NFPs may be forced to reduce their workforce or cut back programs and services. Of particular concern is a lack of availability of affordable lines of credit; increased competition for a smaller pool of contributions; maintaining effective internal controls with a reduced staff; and an increase in delayed or uncollectible pledges, grants, or accounts receivable.

Governance and Accountability

Since the enactment of the Sarbanes-Oxley law in 2002, a number of accounting fraud cases have come to light. Some attribute the increase to improved detection as a result of the stringent internal control testing requirements and other provisions of the law, such as whistle-blower hotlines. Although the whistle-blower and document retention provisions currently apply to both publicly held companies and NFPs, discussions are ongoing regarding transparency and the role of governance in NFPs. One result of these discussions is the focus on disclosure of information about the governing board and policies of NFPs in the redesigned IRS Form 990, Return of Organization Exempt from Income Tax, which is still required to be available for public inspection.

Grant Thornton recently issued their 2008 survey of 652 top level representatives of religious, social and human services, cultural, and health care entities; educational institutions; and trade and professional associations in 42 states and the District of Columbia. According to the survey, 92 percent of NFPs that participated in the survey have made changes to their policies with the goal of improving governance and accountability. The policies that the majority are rewriting or establishing include conflict of interest, investment, code of ethics, records retention, whistle-blower, gift acceptance, review of tax filings, and new board member policies. Most of those surveyed have also developed an accounting policies and procedures manual, established an audit committee to oversee the financial statement audit and monitor internal controls, and included a CPA on their governing board or audit committee.

Corporate Sponsors

Corporate giving increased by almost 1.9 percent in 2007, although it represents only 5.1 percent of the total giving for a total of $15.7 billion. In-kind giving also continues to increase. More than one-third of corporate giving is in-kind. In some circumstances, resources received from corporations are advertising or sponsorship arrangements rather than straightforward monetary contributions, and often, strings are attached to the transfer. Specifically, the corporation may require goods or services in exchange for those funds, such as naming rights, discounted access to services, and advertisement of the company, among others. Because these transactions may be considered exchange transactions, contributions, or both, not-for-profits must be sure that the transactions are properly recorded in their books.

Embedded Giving

Embedded giving, which builds a gift to an NFP into an ordinary consumer purchase, has become a fast growing fundraising practice and an area that has drawn some attention from Congress. Although this practice is effective at raising funds on behalf of charities, issues exist regarding accountability for those funds. NFPs may not be aware that money is being solicited in their name. In addition, they may not know to what portion of the collected funds they are entitled or when they will receive the funds. Consumers may find it difficult to determine whether the money is going to the designated NFP.
Funding Administrative Costs

.31 Foundations, corporations, and individuals may have different priorities when it comes to selecting an NFP to support. Some may consider the entity’s mission, its reputation, the number of people served, or even who else supports it. One factor that frequently receives significant consideration is the percentage of each dollar that is spent on programs. Many donors have the perception that the biggest impact they can make with their contribution is by supporting only programmatic activities. Accordingly, operating expenses such as the accounting department, maintenance and utilities, and the executive management staff often must be supported by unrestricted dollars. Some entities follow policies for cost allocations, charges, assessments, or assignments that result in some amount of program-restricted contributions used for operating expenses. Entities and their auditors should be careful to understand the administrative allocation process and whether overhead costs can be paid for with restricted contributions. In addition, some NFPs are more frequently requesting funding for organizational administration either as a component of or in addition to their requests for program funding. Auditors should develop a full understanding of the terms of these agreements, including whether they result in restrictions on the use of the funds.

Changing Face of Donors

.32 Recently, the desire for control and “a say in” the direction of the mission of entities by young donors has increased. Though no statistics are available, a general belief is that younger, affluent donors want to participate as donors and volunteers to the entities that they support more than their older counterparts. They are more likely to want elements of control as conditions of their gifts. Anonymous giving is also increasing. A study conducted by Indiana University reveals that anonymous gifts greater than $5 million increased from 13 gifts in 2005 to 27 gifts in 2006 and 37 gifts in 2007. Possible reasons for the increase are safety concerns of the donors, adherence to religious principles, a desire to avoid solicitations from other entities, and avoidance of family conflicts. Issues of donor privacy may present unusual problems for auditors as they attempt to confirm the amount and terms of these substantial gifts.

International Giving

.33 The level of international giving by U.S. foundations in 2007 reached a record $5.4 billion. This figure represents a growth rate more than double that of total foundation giving since 2002. Due to the size and missions of these foundations, it is unlikely that the level of giving will decrease despite the current economic situation. An important consideration for auditors is the impact of grant compliance measures related to funding projects in other countries.

Retiring Work Force

.34 The demographic shift in the workplace, as baby boomers near retirement, is affecting the not-for-profit sector. Surveys indicate that 50–70 percent of executive directors plan to leave within 5 years. Many are founders and leaders, closely identified with their entities.

.35 As the sector already suffers from fragile infrastructures, the transitions are expected to be hugely disruptive. Many NFPs devote resources to programmatic functions and do not have executives in training to replace these positions. Succession planning is not seen as a priority.

.36 Auditors may want to consider how the retirement of a key employee, such as the executive director, will affect the NFP’s internal control procedures, its ability to generate revenues and control expenses, and how the entity will address these issues when they arise.

Cyber Donations

.37 The Internet has become the quick and easy means of providing and accessing information. It has also become a tool to expand the audience of NFPs in a way that appeals to younger and more technologically savvy donors. The Internet has thousands of Web sites for NFPs, and most of them provide an opportunity
for a person to contribute. Many of these entities make use of services such as PayPal to permit donors to charge online donations to credit or debit cards. The money is then placed in an account similar to a bank account in the NFP’s name, and a fee is deducted. At some future time, the money is then electronically transferred to another bank account as specified by the NFP. This may be an area that auditors find worthy of attention in that the NFP’s internal controls that are required for these accounts may be different from those for deposit accounts at brick and mortar banks. For example, the entity may have controls regarding who is authorized to sign checks but may not have controls in place to safeguard usernames and passwords for accounts that allow transactions to be initiated through the Internet. One recent twist on both online and embedded giving is the advent of charity gift cards. The recipient of the gift card goes to the card’s Web site and designates which of the listed charities is to receive the donations. Some sites charge an administrative fee at the time of purchase, others when the card is redeemed.

The Independent Sector

.38 In January 2009, the Independent Sector, an advocacy organization for NFPs, released a document, Nonprofit Policy Proposals to Help Strengthen the Ability of Americans to Serve Our Society. The document calls on the Obama Administration and Congress to implement fair and responsible fiscal policies and ensure that government has adequate resources to support vital programs that sustain, protect, and strengthen communities. It also urges Congress to preserve and expand policies such as the Serve America Act and the IRA charitable rollover provision that helps Americans give back to their communities through service opportunities and giving incentives. Additional proposals address the importance of providing nonprofits with the capacity and capital to serve the needs of our communities; increasing the ability of Americans to speak out through NFPs; protecting international charitable activities; and supporting transparency and accountability. The full text of the document can be found at www.independentsector.org/programs/gr/2009_Nonprofit_Platform.htm.

Legislative and Regulatory Developments

IRS Activities

E-Postcard Required for Small Exempt Entities

.39 Beginning in 2008, exempt entities with gross receipts under $25,000 must make an annual electronic filing with the IRS using Form 990-N, Electronic Notification (e-Postcard) For Tax-Exempt Organizations Not Required to File Form 990 or 990–EZ. The e-Postcard is due in 2009 for tax years beginning on or after January 1, 2008. If an entity that is required to file fails to do so for three consecutive years, it will lose its tax exempt status. For more information and a link to the e-Postcard, go to www.irs.gov/charities/article/0,,id=169250,00.html.

Form 990 Redesigned for Tax Year 2008

.40 The IRS issued the final version of Form 990 for tax year 2008 (which will be filed in 2009). The stated goals of the IRS in redesigning Form 990 are enhancing transparency, promoting tax compliance, and minimizing the burden on the filing entity. The basic structure of the new form consists of an 11-page core form, which is to be completed by all filers, and 16 schedules designed by topic (lobbying, related parties, compensation, and so on). A transition period exists for smaller entities, which may allow them to use Form 990-EZ and for certain schedules pertaining to hospitals and tax-exempt bonds. There have also been substantial changes to the amount and type of information that is required on the new Form 990. Some of the more significant changes include the following:

- More questions regarding organizational governance practices
- Disclosure of information from the NFP’s audited financial statements
- Expansion of compensation information disclosures
- Expansion of disclosures regarding programs and activities of the NFP
The IRS issued instructions and a glossary for use with Form 990. More information, an electronic version of Form 990, and the related schedules are available at www.irs.gov/charities/article/0,,id=201398,00.html.

**Department of Treasury and IRS Issue Priority Guidance Plan for 2009**

Fiscal year 2009 priorities are addressed through a flexible and interdisciplinary array of new tools that focus on enforcement of the tax law and improving customer service. Priorities include the following:

- Implementing a voluntary compliance program for delinquent filers
- Addressing the issue of donor control and noncash contributions
- Continuing a variety of compliance projects that focus on areas such as charitable spending initiatives, gifts-in-kind, educational institutions, hospitals, and community foundations.
- Initiatives focused on identifying nonfilers in the gaming, employment tax, and tax-exempt entity areas
- A further focus on transparency and governance by tax exempt entities
- Developing a new compliance guide, known as a *cyber assistant*, and formal guidance on hot topics such as Form 990 revisions

Additional information on these and other topics is available at www.irs.gov/pub/irs-tege/finalannualrptworkplan11_25_08.pdf.

**Exempt Entity Abusive Tax Avoidance Transactions**

Tax-exempt entities, by definition, are exempt from federal income tax under various provisions of the Internal Revenue Code (IRC). However, some are directly involved in Abusive Tax Avoidance Transactions (ATATs). In addition, because they are tax-indifferent, tax-exempt entities are, at times, used by for-profit entities as accommodation parties in these transactions. Identifying and responding to ATATs involving tax-exempt entities is critical to the IRS objective of discouraging and deterring noncompliance within tax-exempt and government entities.

As a result of provisions included in the Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005, the Treasury Department and IRS have issued proposed and temporary regulations under IRC Section 4965, which imposes excise taxes and disclosure requirements with respect to prohibited tax shelter transactions to which tax-exempt entities are parties. The regulations provide (1) rules regarding the form, manner, and timing of disclosure obligations, and (2) return requirements accompanying payment of excise taxes. The deadline for submitting comments on the proposed regulations has passed. IRS guidance addresses the following issues under this legislation:

- Which entities and individuals are subject to excise tax under the new provisions and which taxes and penalties may apply
- Who is a party subject to the new provisions, and the treatment of proceeds of transactions received before the effective date of the new provisions
- Disclosure and filing requirements

Additional information is available at www.irs.gov/charities/article/0,,id=172158,00.html.

**Certain Charitable Contributions Designated as Transactions of Interest Under Reportable Transaction Regulations**

In September 2007, the IRS issued Notice 2007-72, designating certain transactions as having the potential for tax avoidance or evasion and alerting participants to required disclosures and potential penalties.
In the transactions, a taxpayer transfers a membership interest in a limited liability company that directly or indirectly owns real property to a Section 501(c)(3) charitable entity or government entity, claiming a charitable contribution deduction for an amount significantly higher than the original purchase price paid by the taxpayer to acquire the interest. Charitable entities that receive property in these transactions after August 14, 2007 are participants in these transactions for the first year in which their tax returns reflect the acquired interest, which is generally the year of receipt of the interest. For that year, the charity must disclose certain information required by the reportable transaction regulations to the IRS or be subject to penalties as described in the notice. The IRS has begun notifying entities that have participated in these transactions that they have been selected for examination.

Prohibition Against Political Activities

.48 The prohibition against political campaign activity has been in effect for more than half a century and bars certain tax-exempt entities from engaging on behalf of or in opposition to political candidates. However, these entities can engage in advocating for or against issues and, to a limited extent, ballot initiatives or other legislative activities.

.49 The IRS’s goal is to educate the leadership of these entities to help them stay within the legal boundaries. In this regard, IRS Revenue Ruling 2007-41 outlines a number of scenarios to help charities and churches understand the ban on political campaign activity and actions that may arise.

.50 In addition to the revenue ruling, the IRS has other helpful information for churches and charities on its Web site, www.irs.gov/charities/index.html. For example, IRS Publication 1828, “Tax Guide for Churches and Religious Organizations,” contains a discussion of the law affecting political campaign activity by churches and religious institutions.

.51 Violation of the law can result in imposition of an excise tax or, in extreme cases, a loss of tax exempt status.

Employment Taxes and Classifying Workers

.52 In December 2007, the IRS issued Fact Sheet (FS) 2007-27 to help entities better understand their responsibilities regarding employment taxes and classifying workers. To access this guidance, which provides criteria to better understand the regulations, go to www.irs.gov/newsroom/article/0,,id=177092,00.html.

.53 Additionally, in November 2007, FS 2007-25 was issued, which outlines the IRS initiative regarding compliance with employer tax regulations. This initiative includes both IRS and various state workforce agencies that will work together and exchange information to improve taxpayer compliance in this complicated area.

Internet-Based Workshop for Exempt Entities

.54 The IRS has a Web-based version of its popular Exempt Organizations Workshop covering tax compliance issues confronted by small and mid-sized tax exempt entities.

.55 The free online workshop, Stay Exempt—Tax Basics for 501(c)(3)s, consists of five interactive modules on tax compliance topics for exempt entities:

• Tax-Exempt Status—How can you keep your 501(c)(3) exempt?
• Unrelated Business Income—Does your entity generate taxable income?
• Employment Issues—How should you treat your workers for tax purposes?
• Form 990—Would you like to file an error-free return?
• Required Disclosures—To whom do you have to show your records?
Users can access this new training program at www.stayexempt.org. Users can complete the modules in any order and repeat them as many times as they like. The online training Web site does not require registration, and its visitors will remain anonymous.

**Fast Track Settlement Program**

In December 2008, the IRS announced an opportunity for entities with issues under examination by the Tax Exempt and Governmental Entities Division (TE/GE) to use Fast Track Settlement (FTS) to expedite case resolution. The TE/GE FTS will enable TE/GE entities that currently have unresolved issues in at least one open period under examination to work together with TE/GE and the Office of Appeals (Appeals) to resolve outstanding disputed issues while the case is still in TE/GE jurisdiction. TE/GE and Appeals will jointly administer the TE/GE FTS process. TE/GE FTS will be used to resolve factual and legal issues, and it may be initiated at any time after an issue has been fully developed, but before the issuance of a 30-day letter or its equivalent. TE/GE FTS will be available to taxpayers for a pilot period of up to 2 years, beginning in December 2008. Upon completion of the 2-year pilot period, TE/GE and Appeals will evaluate the program, consider necessary adjustments, and determine whether to make the program permanent. More information is available at www.irs.gov/irb/2008-48_IRB/ar14.html#d0e2519.

**Resource Materials—Compliance Initiatives for Tax-Exempt Entities**

The Exempt Organization Division of the IRS has made materials available that were used in or which discuss its compliance initiatives including limited liability company projects, community foundations, bond compliance, hospitals, and executive compensation. You can find this material at www.irs.gov/charities/article/0,,id=162493,00.html.

**Listing of Published Guidance—2009**

Readers should be aware that the IRS Web site contains a digest of published guidance for tax exempt entities issued in 2009 at www.irs.gov/charities/content/0,,id=202419,00.html. The published guidance includes treasury regulations, revenue rulings, revenue procedures and notices, and announcements of recently published issues of interest to tax-exempt entities.

Additionally, the IRS Web site also contains an archive that presents digests of IRS published guidance of interest to tax-exempt entities for the years 1954–2008. The archived guidance can be found at www.irs.gov/charities/article/0,,id=151053,00.html.

**Uniform Prudent Management of Institutional Funds Act**

In July 2006, the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved the Uniform Prudent Management of Institutional Funds Act (UPMIFA) and recommended it for enactment by the legislatures of the various states. UPMIFA is designed to replace the existing Uniform Management of Institutional Funds Act (UMIFA), which was approved by NCCUSL in 1972. The purpose of UMIFA was to provide uniform and fundamental rules for the investment of funds held by charitable institutions and the expenditure of funds donated as “endowments” to those institutions. The principles behind those rules were

- that assets would be invested prudently in diversified investments that sought growth as well as income, and
- that appreciation of assets could prudently be spent for the purposes of any endowment fund held by a charitable institution.

Since its creation, UPMIFA has been enacted in 47 states. In response to the increasing size and complexity of charitable endowments held in investments, UPMIFA was created based on the same principles. As of March 2009, UPMIFA has been enacted in 28 states and the District of Columbia and is pending legislation in 14 additional states.
In August 2008, FASB issued FASB Staff Position (FSP) FAS 117-1, *Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures for All Endowment Funds*, effective for fiscal years ending after December 15, 2008. The FSP

- provides guidance on the net asset classification of donor-restricted endowment funds for NFPs that are subject to an enacted version of UPMIFA. (As of March 15, 2009, 28 states and the District of Columbia had enacted a version of UPMIFA, with legislation pending in several other states.)
- improves disclosures about an NFP’s endowment funds (both donor-restricted and funds functioning as endowment), whether or not the NFP is subject to UPMIFA.

The first, and perhaps most significant question the FSP addresses is how UPMIFA’s elimination of the historic-dollar-value threshold—the amount below which an NFP could not spend under UMIFA—affects net asset classification. The FSP requires an NFP to classify a portion of a donor-restricted endowment fund (other than a term endowment) as permanently restricted net assets. That portion would be equal to the amount of the fund (a) that must be retained permanently in accordance with explicit donor stipulations, or (b) that, in the absence of such stipulations, the NFP’s governing board determines must be retained permanently, if any, under the relevant law. The NFP would be required to disclose its interpretation of the law. We anticipate that discussions among NFPs, accountants, attorneys, and regulators in the various individual states may lead to a consensus in those states determining what must be retained permanently under the law. If a governing board determines that the law requires maintenance of purchasing power of a donor’s gift, the NFP would increase permanently restricted net assets to the extent that the purchasing power of a dollar decreases or decreases permanently restricted net assets to the extent that the purchasing power of a dollar increases. (This would typically be done by adjusting permanently restricted net assets by an appropriate inflationary factor, such as the consumer price index [CPI] or higher education price index [HEPI].)

In contrast, an NFP would not subsequently decrease permanently restricted net assets because of investment losses or organizational spending from the endowment but would, instead, decrease temporarily restricted net assets, if available, or unrestricted net assets. The guidance on investment losses and spending is consistent with the guidance previously provided on investment losses in FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, paragraph 12. FASB considered, but decided not to, change that guidance, noting that permanently restricted net assets should reflect the amount for which an NFP has a permanent fiduciary duty and not the amount that it has on hand at a financial statement date because of cumulative investment and spending decisions.

The FSP also addresses whether two other provisions in UPMIFA’s endowment spending guidelines impose temporary (time) restrictions on the portion of a donor-restricted endowment fund that would otherwise be considered unrestricted net assets:

- A provision that “[u]nless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution”
- An optional provision for a rebuttable presumption that spending more than 7 percent of endowment market value is imprudent (Some states have included this provision, whereas others have not.)

The FSP requires NFPs to apply the guidance previously provided in Emerging Issues Task Force (EITF) Topic No. D-49, “Classifying Net Appreciation on Investments of a Donor-Restricted Endowment Fund,” included as an appendix to the FSP. EITF Topic No. D-49 stresses that not all legal restrictions on the use of particular assets result in restricted net assets for accounting purposes, only those that extend donor restrictions. An example of the latter would be a requirement to maintain the purchasing power of a donor’s endowment gift. Laws that refer to actions entirely within the purview of a governing board, such as acting to appropriate funds or exercising prudence do not, in and of themselves, extend donor imposed restrictions.

The other key provisions of the FSP focus on improving endowment disclosures both for donor-restricted and board-designated endowment funds. Aiming to improve transparency about endowments in an era of increased public scrutin, the FSP focuses on disclosures in four areas:
• Net asset classification (especially how that is affected by a governing board’s interpretation of relevant law)
• Spending policies
• Investment policies (especially their relationship with spending policies)
• Net asset composition and changes therein (especially the relationship of endowment spending to endowment size and growth)
• Reconciliation of beginning and ending balances of the endowment in total and by asset class

New Filing and Audit Requirements for ERISA-Covered 403(b) Employee Benefit Plans

.69 Beginning in 2009, employee benefit plans sponsored by charitable entities and schools under IRC Section 403(b) and covered under the Employee Retirement Income Security Act (ERISA) will be subject to the same reporting and audit requirements that currently exist for Section 401(k) plans. Section 403(b) plans are also commonly known as tax-shelter annuity plans. Under new U.S. DOL regulations issued in November 2007 amending the filing requirements for Form 5500, Annual Return/Report of Employee Benefit Plan, ERISA-covered 403(b) plans with 100 or more participants generally will be required to file audited financial statements beginning with their 2009 Form 5500 filing. 403(b) plans with fewer than 100 participants will be eligible to use abbreviated reporting forms without audited financial statements. The DOL estimates that approximately 7,000 403(b) plans will be subject to the new audit requirements and another 9,000 403(b) plans will be eligible for the waiver. The DOL regulations were published in the November 16, 2007 Federal Register and are available at www.dol.gov/ebsa/regs/fedreg/final/20071116.pdf. The AICPA Employee Benefit Plan Audit Quality Center (EBPAQC) (www.aicpa.org/EBPAQC) and Expert Panel have formed a joint task force to develop resources to help members with these new audit requirements.

Other Regulatory Activities

.70 The following list provides links to documents of interest for NFPs not discussed elsewhere in this alert. Readers should continue to monitor all activity involving the NFP sector.
• U.S. Department of the Treasury Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities at www.ustreas.gov/offices/enforcement/key-issues/protecting/charities-intro.shtml. This link also contains the Treasury’s response to comments submitted on the original guidelines. The Treasury has also issued a risk matrix to further assist in understanding and implementing these guidelines. The matrix can be found at www.ustreas.gov/offices/enforcement/ofac/policy/charity_risk_matrix.pdf.
• The Honest Leadership and Open Government Act of 2007 (September 2007) requires disclosures related to lobbying and earmarks. The full text of the bill can be found at www.thomas.gov/cgi-bin/bdquery/z?d110:s.00001:.

Audit and Attestation Issues and Developments

Audit Risks Arising From Current Economic Conditions

.71 The recent economic conditions and regulatory actions described in this alert may cause additional risk factors that had not previously existed or did not have a material effect on audit clients in prior years. Some risks that may affect an entity in the current economic environment are as follows:
• Constraints on the availability of capital and credit
• Going concern and liquidity issues
• Marginally achieving explicitly stated strategic objectives
• Use of off-balance-sheet financing
• Special purpose entities, joint ventures, or other complex financing arrangements
• Volatile real estate markets
• The credit crisis, which results in significant measurement uncertainty, including accounting estimates and fair value measurements
• Operations that are exposed to volatile markets

.72 Although many of these risks are not new to NFPs, consideration of the ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks. As noted in paragraph .17 of AU section 312, some possible audit responses to a significant risk of material misstatement include increasing the extent of audit procedures, performing procedures closer to year-end, or increasing audit procedures to obtain more persuasive evidence. Additionally, given the constant changing status of economic conditions that could affect your client, auditors should consider modifying audit procedures to ensure that risks are still adequately addressed.

.73 Although it is impossible to predict and include all accounting, auditing, and attestation issues that may affect your engagements, we cover in this alert the primary areas of concern affected by the current economic conditions. Continue to remain alert to economic, legislative, and regulatory developments as well as the associated accounting, auditing, and attestation issues as you perform your engagements.

Auditor’s Use of Reports on Service Organizations

.74 Many entities use outside service organizations to accomplish tasks that affect the entity’s financial statements. Service organizations provide services ranging from performing a specific task under the direction of an entity to replacing entire organizational units or functions of an entity. Over time, there has been a significant increase in the use of service organizations. Because many of the functions performed by service organizations affect an entity’s financial statements, auditors performing audits of the financial statements of entities utilizing service organizations may need to obtain information about those services, the related service organization controls, and their effects on an entity’s financial statements.

.75 Examples of service organizations that perform functions that may affect other entities’ financial statements are bank trust departments that invest and service assets for employee benefit plans or, for others, lockbox service providers that collect and process payments such as contributions or dues; payroll processing companies that issue payroll checks and remit payroll taxes on behalf of an entity; mortgage bankers that service mortgages for others; and application service providers that provide packaged software applications and a technology environment that enables customers to process financial and operational transactions.

.76 An auditor may be engaged to issue a report on a service organization’s controls for use by user entities and their auditors. Statement on Auditing Standards (SAS) No. 70, Service Organizations, as amended (AICPA, Professional Standards, vol. 1, AU sec. 324), provides guidance to an auditor performing (1) an audit of a user entity’s financial statements, and (2) procedures at a service organization that will enable the auditor to issue a service auditor’s report on a service organization’s controls that may be part of user entities’ information systems. Although a service auditor’s report may be used by management of a service organization and its user entities, its primary purpose is to provide information to auditors who audit user entities’ financial statements.

.77 AU section 314 states that the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. In certain situations, an entity’s internal control extends beyond the controls within its physical facility or internal operations. This can happen if an entity uses another organization to perform services that are a part of the entity’s information system. If a user auditor determines that the controls at a service organization are significant when assessing the risks of material misstatement of the user entity, the user
auditor should gain an understanding of the service organization’s controls sufficient to assess the risks of material misstatement.

.78 SAS No. 70, as amended, is not applicable to every control provided by the service organization. It is applicable only if the services provided are part of the user entity’s information system, and the related controls are included in the scope of the auditor’s examination. A service organization’s services are part of the user entity’s information system if they affect any of the following:

- The classes of transactions in the user entity’s operations that are significant to the user entity’s financial statements
- The procedures, both automated and manual, by which the user entity’s transactions are initiated, authorized, recorded, processed, and reported from their occurrence to their inclusion in the financial statements
- The related accounting records, whether electronic or manual, supporting information, and specific accounts in the financial statements involved in initiating, authorizing, recording, processing, and reporting the user entity’s transactions
- How the user entity’s information system captures other events and conditions that are significant to the financial statements
- The financial reporting process used to prepare the user entity’s financial statements, including significant accounting estimates and disclosures

.79 The guidance in SAS No. 70, as amended, is not relevant to situations in which

- the services provided are limited to executing the user entity’s transactions that are specifically authorized by the user, such as the processing of checking account transactions by a bank or the execution of securities transactions by a broker.
- the audit of transactions arising from financial interests in partnerships, corporations, and joint ventures, such as working interests in oil and gas ventures, when proprietary interests are accounted for and reported to interest holders.

Types and Content of Independent Service Auditors’ Reports

.80 A SAS No. 70 report is intended to provide information about the controls at a service organization that may be relevant to the user entity’s internal control as it relates to the user entity’s financial statements. A service auditor may provide a service organization with two types of reports:

1. A report on controls placed in operation, which will be referred to as a type 1 report in this alert.
2. A report on controls placed in operation and tests of operating effectiveness, which will be referred to as a type 2 report in this alert.

.81 Paragraph 24 of SAS No. 70 states that the type of engagement to be performed and the related report to be prepared should be established by the service organization. However, when circumstances permit, discussions between the management of the service organization and the managements of the user entities are advisable to determine the services or applications that will be covered by the report and the type of engagement and related report that will be most useful to the user entities and their auditors.

.82 A type 1 report is intended to provide user auditors with information about the controls at a service organization that may be relevant to a user entity’s internal control as it relates to an audit of financial statements. This information, in conjunction with other information about a user entity’s internal control, can assist the user auditor in obtaining a sufficient understanding of the user entity’s internal control to assess the risks of material misstatement and design the nature, timing, and extent of further audit procedures, as described in paragraphs .40–.101 of AU section 314. The user auditor obtains this understanding to enable him or her to (1) identify the types of misstatements that may occur in a user entity’s financial statements; (2)
consider the factors that affect the risks of material misstatement; (3) when applicable, design tests of controls; and (4) design substantive procedures. A type 1 report, however, is not intended to provide a user auditor with a basis for reducing his or her assessment of control risk to low or moderate. Paragraph 38 of SAS No. 70, as amended, presents an example of a service auditor’s report for a type 1 engagement.

.83 In a type 2 engagement, the service auditor performs the procedures required for a type 1 engagement and also performs tests of specific controls to evaluate their operating effectiveness in achieving specified control objectives. In accordance with paragraph .42 of AU section 318, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (AICPA, Professional Standards, vol. 1), tests of operating effectiveness include obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied. The service auditor issues a report that includes the type 1 report opinions and refers the reader to a description of tests of operating effectiveness performed by a service auditor. The report states whether, in the opinion of the service auditor, the controls tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.

.84 If a service organization’s controls (the controls that may affect a user entity’s financial statements) are operating with sufficient effectiveness to achieve the related control objectives, a user auditor may be able to assess control risk low or moderate for relevant financial statement assertions affected by the service organization’s service or processing and, consequently, may be able to reduce the extent of substantive procedures performed for those assertions. To assess control risk low or moderate, a user auditor should consider the operating effectiveness of the relevant service organization controls in conjunction with the user entity’s internal control. In considering the operating effectiveness of the relevant controls at the service organization, the user auditor should read and consider both the service auditor’s

- report on the operating effectiveness of the controls and
- description of the tests of the operating effectiveness of controls that may be relevant to specified assertions in the user entity’s financial statements and the results of those tests.

.85 Under no circumstances can the service auditor’s report (the letter issued by the service auditor) be the only basis for reducing the assessed level of control risk. The user auditor should read and consider both the report and the evidence provided by the tests of operating effectiveness and relate them to the relevant assertions in the user entity’s financial statements. Although a type 2 report may be used to reduce substantive procedures, neither a type 1 report nor a type 2 report is designed to provide a basis for assessing control risk sufficiently low to eliminate the need for performing any substantive tests for all of the assertions relevant to significant account balances or transaction classes. Paragraph .51 of AU section 318 states that regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. Paragraph 54 of SAS No. 70, as amended, presents an example of a service auditor’s report for a type 2 engagement.

Companion Audit Guide

.86 The AICPA Audit Guide Service Organizations: Applying SAS No. 70, as Amended (product no. 012778kk) is designed to provide guidance to service auditors engaged to issue reports on a service organization’s controls that may be part of a user entity’s information system in the context of an audit of financial statements. It also provides guidance to user auditors engaged to audit the financial statements of entities that use service organizations. The guide can be ordered by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.
Tax Exempt Bonds—Accounting and Auditing Considerations in the Current Environment

.87 The current credit environment has affected the market for debt securities. For example, several entities that insure tax exempt debt have been downgraded by rating agencies, and some investors have avoided certain debt securities. Although each situation is different and should be evaluated based on its own specific facts and circumstances, the current situation may raise various accounting and auditing issues pertaining to tax exempt debt, including, but not limited to, the following:

- Bond restructurings
- Derivative and hedge accounting implications
- Potential violation of debt covenants
- Classification of the debt on the balance sheet as either a current or noncurrent liability
- Subsequent event disclosures
- Going concern issues

.88 An ad hoc AICPA member task force developed a nonauthoritative article to address these issues in more detail. This article can be found at www.aicpa.org/download/acctstd/ARS_article14.pdf.

Liquidity Considerations

.89 Technical Questions and Answers (TIS) section 1100.15, “Liquidity Restrictions” (AICPA, Technical Practice Aids), addresses potential accounting and auditing implications when a fund or its trustee imposes restrictions on a nongovernmental entity’s ability to withdraw its balance in a money market fund or other short-term investment vehicle. This question and answer discusses some considerations for when these restriction events occur, such as determining (a) whether any assets subject to these restrictions qualify as cash equivalents or current assets; (b) whether disclosures about the risks and uncertainties resulting from such restrictions should be made; (c) whether these restrictions may trigger violations of debt covenants and, if so, whether that liability should be classified as current; (d) whether the financial statements need to be adjusted if the occurrence of such restriction occurs between the balance sheet date and the issuance date; and (e) whether the restriction events call into question the entity’s ability to continue as a going concern.

.90 Auditors should consider whether any additional disclosures made by management include forward-looking statements that are not required by generally accepted accounting principles (GAAP) and, therefore, may not be audited. Auditors also should consider whether the inability to withdraw funds can pose significant challenges to the entity’s liquidity and, therefore, affect the entity’s ability to continue as a going concern. Restrictions on liquidity also may be an appropriate matter to communicate to those charged with governance. Finally, the auditor should consider if he or she wishes to emphasize any liquidity restrictions in the auditor’s report. For further details, see the question and answer at www.aicpa.org/download/acctstd/TIS1100_15.pdf.

Alternative Investments

.91 The AICPA practice aid Alternative Investments—Audit Considerations is a useful tool for auditors that focuses on the existence and valuation assertions associated with alternative investments but also discusses general considerations pertaining to auditing alternative investments, management representations, disclosure of certain significant risks and uncertainties, and reporting. As defined in the foreword of the practice aid, alternative investments are investments for which a readily determinable fair value does not exist ... includ[ing] private investment funds meeting the definition of an investment company ... such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as bank common/collective trust funds.
Further, as discussed in a meeting of FASB’s Valuation Resource Group, net asset value of a fund may not represent fair value under FASB Statement No. 157. Given the state of the economy, many funds are imposing limitations on redemptions, and some are even unwinding. As this occurs, the fair value measurements applied to these investments will fall under increased scrutiny and become even more important.

Auditing Fair Value Measurements

In addition to understanding the looming questions relative to fair value accounting, auditors should be aware of audit issues involving fair value accounting. Particular assets, liabilities, and components of equity are measured or disclosed at fair value in the financial statements, and it is management’s responsibility to make the fair value measurements and disclosures. When auditing these fair values to ensure they are in conformity with GAAP, auditors should consult AU section 328, Auditing Fair Value Measurements and Disclosures (AICPA, Professional Standards, vol. 1), which establishes standards and provides guidance for auditors. Specific types of fair value measurements are not covered by AU section 328. For example, when auditing the fair value of derivatives and securities, refer to AU section 332, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities (AICPA, Professional Standards, vol. 1).

In regard to analyzing the sufficiency of the audit evidence, the strongest audit evidence to support a fair value is an observable market price in an active market. If that is not available, a valuation method should incorporate common market assumptions. If common market assumptions are not available or require significant adjustments, the entity may use its own assumptions. The auditor should obtain an understanding of the entity’s process for determining fair values, as well as whether the fair value measurements and disclosures are in accordance with GAAP. During this testing, the auditor also may identify any possible indicators of impairment. According to paragraph .23 of AU section 328, substantive tests of the fair value measurements may involve (a) testing management’s significant assumptions, the valuation model, and the underlying data; (b) developing independent fair value estimates for corroborative purposes; or (c) reviewing subsequent events and transactions. Paragraph .26 also notes that when testing the fair value measurements and disclosures, the auditor evaluates whether management’s assumptions are reasonable and reflect or are not inconsistent with market information. In relation to FASB Statement No. 157, this might include whether the market is distressed, whether the transaction was an orderly transaction, the reasonableness of the determination within the fair value hierarchy of inputs, and the reasonableness of the underlying assumptions.

Fair Values of Securities

The guidance in AU section 332 relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, there are some specific items of note for the auditor. As previously mentioned, quoted market prices in active markets are the best available audit evidence to support a fair value; however, when they are unavailable and the valuations of securities are obtained from a broker or dealer or another pricing service based on valuation models, the auditor should understand the underlying valuation method used (such as a cash flow projection). These prices also may be based on quoted prices from an active market or other observable inputs that will be a consideration on the auditor’s procedures as well. The process used by the pricing service in measuring fair value should be evaluated to determine the consistency with the specified valuation method (typically, fair value, as defined in FASB Statement No. 157). The auditor also may determine that it is necessary to obtain quotes from more than one pricing source based on circumstances such as an existing relationship between the entity and the valuing entity, which could inhibit objective pricing or underlying valuation assumptions that are highly subjective. In the context of FASB Statement No. 157, quoted prices in active markets are considered level 1 inputs.

When an entity performs its own valuation, value testing procedures include

- assessing the reasonableness,
• comparing the assumptions to industry reports or benchmarks,
• assessing the appropriateness of the model,
• calculating the value using his or her own model, and
• comparing the fair value with subsequent or recent transactions.

.98 Whether or not the inputs to the entity’s valuation model are observable determines their characterization as level 2 or level 3 inputs, respectively, within FASB Statement No. 157. When extensive judgment is needed, consider using a specialist or refer to AU section 342, Auditing Accounting Estimates (AICPA, Professional Standards, vol. 1). Additionally, when the underlying collateral of a security significantly contributes to its fair value and collectability of the security, evidence of the collateral also should be examined for existence, fair value, transferability, and the investor’s right to the collateral.

.99 Paragraph .19 of AU section 328 also notes that the auditor should evaluate whether the entity’s method for determining fair value measurements is applied consistently and, if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the entity or changes in accounting principles. The auditor should obtain an understanding of management’s classification process among trading, available-for-sale, and held-to maturity, as well as consider the classifications in light of the entity’s current financial position.

Auditing Accounting Estimates

.100 As noted in paragraph .04 of AU section 342, the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements as a whole. Although this alert has discussed fair value measurements at length, it is important to remember many types of accounting estimates exist in client financial statements. Some examples include the allowance for uncollectible accounts receivable, impairment analysis and estimated useful lives of long-lived assets, valuation allowance for deferred tax assets, and actuarial assumptions in pension and other postretirement benefit costs.

.101 Given the current economic climate, additional skepticism should be exercised when considering management’s underlying assumptions used in accounting estimates. When evaluating accounting estimates, the auditor should consider both the subjective and objective factors with professional skepticism. As discussed in paragraph .09 of AU section 342, key factors and assumptions that the auditor normally concentrates on include the assumptions that are significant to the estimate, sensitive to variations, deviations from historical patterns, or are particularly subjective and susceptible to misstatement and bias; however, it is important to consider whether historical patterns are still applicable.

.102 For example, in the current slow market, new patterns may emerge. In this economic climate, with possible increasing pressure on management to meet budgets, a key aspect of AU section 342 is for an auditor to determine the reasonableness of management’s accounting estimates with an extra degree of professional skepticism. As noted by AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), when assessing audit differences between client estimates and audit estimates, even if they are individually reasonable, an auditor should consider whether these differences are indicative of possible bias by management. If so, the auditor should reconsider the estimates as a whole.

.103 The auditor should obtain an understanding of how management develops estimates and employ one of the approaches outlined in paragraph .10 of AU section 342 in testing that process. In reviewing and testing management’s process, the auditor may consider identifying controls around this process and determining if the underlying data used for the estimate are reliable and used appropriately. An auditor also may develop an estimate and compare it to management’s estimate. Lastly, the auditor may review subsequent events or transactions occurring prior to the date of the auditor’s report. Further, as noted in AU section 316, hindsight may provide the auditor additional insight into the existence of management bias. For further details on auditing estimates, see AU section 342.
Using the Work of a Specialist

.104 It may be necessary to use a specialist (such as a securities valuation expert) to assist in auditing complex or subjective matters. Examples of matters in which an auditor may engage a specialist are valuation issues; reasonableness of determination of amounts derived from specialized techniques or models; or implementation of technical requirements, regulations, or legal documents. AU section 336, Using the Work of a Specialist (AICPA, Professional Standards, vol. 1), provides guidance to auditors in using specialists. The guidance in AU section 336 is applicable when the specialist is hired by management or if the auditor engages the specialist. However, if a specialist employed by the auditor’s firm participates in the audit, AU section 311, Planning and Supervision (AICPA, Professional Standards, vol. 1), is applicable rather than AU section 336.

.105 When using the work of a specialist, the auditor should evaluate the specialist’s professional qualifications, obtain an understanding of the nature of the work performed or to be performed, and evaluate the relationship of the specialist to the client in terms of objectivity. Although the appropriateness and reasonableness of the methods and assumptions employed by the specialist are his or her responsibility, the auditor should obtain an understanding of these qualities, test the underlying data provided to the specialist, and evaluate the specialist’s findings in the context of the audit and related assertions in the financial statements.

Consideration of an Entity’s Ability to Continue as a Going Concern

.106 The consideration of an entity’s ability to continue as a going concern is required in every audit performed under generally accepted auditing standards and is an especially important consideration in the current state of the economy. An entity’s ability to continue as a going concern is affected by many factors related to the current uncertain economy, such as the industry and geographic area in which it operates and the financial health of its donors, customers, and suppliers, and financing sources.

.107 As explained by paragraph .02 of AU section 341, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern (AICPA, Professional Standards, vol. 1), the auditor’s evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor’s report. Therefore, this is an ongoing evaluation that extends through the date of the auditor’s report.

.108 The auditor has a responsibility to evaluate whether there is a substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time. AU section 341 notes that is a period not to exceed one year beyond the date of the financial statements being audited.

.109 Audit teams may find it useful to have preliminary discussions about going concern considerations during engagement planning meetings; however, as noted in AU section 341, it is not necessary to design audit procedures around specifically identifying the possibility of a going concern because results of typical audit procedures should illuminate any indicators. These procedures may consist of analytical procedures, review of subsequent events, review of compliance with financing agreements, review of board minutes, inquiry of legal counsel, and confirmation with related third parties of the details of arrangements to provide or maintain financial support.

.110 Some risks related to the current state of the economy that may influence an entity’s ability to continue as a going concern include the following:

- Lenders may be looking for ways to withdraw from lending relationships.
- Financial support of a related party may not be a feasible mitigating factor, depending on the financial health of that related party.
- An entity’s financial health could be significantly weakened if their donors or members have been strongly affected by the economic crisis.
- Projections provided by entities based on historical data may not be reliable future predictions.
- Some entities may be hesitant to include informative and transparent going concern disclosures.
If the auditor believes a substantial doubt on the entity’s ability to continue as a going concern exists, the next steps are to obtain management’s plans to mitigate the effect of such conditions and then assess the likelihood that these plans can be effectively implemented. Additionally, auditors may consider posing the following questions to help make their assessment on the likelihood of management’s plans to successfully mitigate their going concern risk:

- What is the strategy for extending lines of credit or refinancing any debt coming due? Have any preliminary agreements or discussions occurred?
- If negative operating trends exist, how does management plan on turning them around?
- If turnover of key personnel has occurred, what actions are being taken to replace these positions?
- What is the plan to maintain or increase the liquidity of your balance sheet?
- Do any restrictions exist that could limit management’s ability to carry out these plans?

If, after considering management’s plan, an auditor determines a substantial doubt about an entity’s ability to continue as a going concern for a reasonable period of time remains, the auditor should communicate with those charged with governance of the entity, in accordance with AU section 341.

In that instance, the auditor also should consider the effects on the entity’s financial statements and the adequacy of the related disclosure, and an explanatory paragraph should be added to the audit report following the opinion paragraph.

Alternatively, if management’s plan mitigates the risk of the entity’s ability to continue as a going concern, the auditor should consider disclosing the primary conditions that gave rise to the initial doubt and management’s plans. These disclosures are especially important for financial statement users to fully comprehend the entity’s financial strength and ability to continue as a going concern.

FASB has undertaken a project that will relocate the guidance related to going concern from the realm of auditing standards to accounting standards. See the “On the Horizon” section of this alert for further details.

### Consideration of Fraud in a Financial Statement Audit

AU section 316 is the primary source of authoritative guidance about an auditor’s responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, as stated in paragraph .02 of AU section 110, Responsibilities and Functions of the Independent Auditor (AICPA, Professional Standards, vol. 1).

Three conditions generally are present when fraud occurs:

- Management or other employees have an incentive or are under pressure, which provides a reason to commit fraud.
- Circumstances exist (for example, the absence of controls, ineffective controls, or the ability of management to override controls) that provide an opportunity for a fraud to be perpetrated.
- Those involved are able to rationalize committing a fraudulent act.

The current economic situation may result in unexpected losses and possibly cause financing or liquidity difficulties for many entities. Additionally, management may be valuing many illiquid securities using inherently subjective methodologies. These situations may provide management additional opportunity and incentive to commit fraud.

Auditors of small NFPs are aware that internal control effectiveness is frequently an issue due to limitations inherent in entities of this size. Lack of segregation of duties, qualified accounting staff, training, and understanding of the purpose and operation of effective internal control contribute to the risk of fraud.
in these entities. Small NFPs often feel that they cannot afford to hire qualified accounting specialists, are unable to adequately separate financial responsibilities among very few staff members, or do not have the resources to create effective controls. As a result, opportunities to commit fraud may exist to a greater extent in small NFPs than in larger, more complex NFP entities.

.120 As seen in the news recently, a number of frauds that include the three previously mentioned conditions allegedly have occurred. One of those frauds is that of Bernard Madoff Investment Securities. Although the details of this fraud are just beginning to be investigated, auditors should ensure they are properly testing for the existence of assets, such as investments, in accordance with AU section 332. Additionally, auditors should always gain an understanding of the entity's business and how profits are made. In the Madoff case, auditors are being probed about failing to question the strong, consistent annual returns by these investment funds that lacked a clear investment strategy. Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud.

.121 Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. AU section 316 provides additional information, including ways for the auditor to respond to the risk of material misstatement due to fraud.

Evaluating the Existence of Assets

.122 The Madoff case, and other alleged frauds, brings to light a number of risks that continually need to be considered and responded to by management and auditors. Due to the nature of securities and other financial instruments, determining and testing the ownership and existence of investments has become more difficult. Often, securities and other investments purchased on behalf of an entity are held in the name of a broker organization, which may or may not be a custodian; and generally, custodians do not obtain a paper document anymore, only an electronic record of the assets.

Some examples of risks inherent in investment transactions that may be relevant when assessing existence are as follows:

- The assets involved may not be readily available to physical inspection.
- There could be a lack of effective, independent, third party oversight.
- The information received from a broker organization, in the form of monthly statements or in response to audit confirmation requests, may require further verification to assess its reliability.
- There may be a lack of experience on the part of the client with these types of transactions and, therefore, controls over existence may be nonexistent or poorly designed.
- The transactions may be complex in nature, making them difficult to understand.

.123 Management has a responsibility to design an internal control system that is responsive to the risk of existence of assets (in addition to the valuation of assets). As part of their risk assessment procedures, auditors need to assess those controls and determine if the controls have been implemented. Depending on the results of those assessments, the auditor should design an audit strategy that takes into consideration the entity's controls, including testing those controls if those controls are to be relied upon and used as part of the auditor's audit evidence regarding the existence assertion. If the auditor's assessment indicates that management's design or operation of controls are not effective, then those deficiencies should be communicated to those charged with governance if the control deficiency is a significant deficiency or material weakness.

.124 Examples of controls at the entity that are designed to assess the existence of assets could include the following:
• Obtaining through site visits and documenting an understanding of existence controls placed in
operation by any service organization that is utilized by the entity and periodically reassessing that
understanding

• Obtaining evidence, through direct testing or a SAS 70 type 2 report that the service organization’s
existence controls are appropriately designed and operating effectively

• Inspecting other documentation supporting the entity’s interest in the security (for example, corre-
spondence from the broker organization or trustee acknowledging transactions with the fund)

Communication With Those Charged With Governance

.125 In addition to instances in which communication with those charged with governance in other
auditing sections is discussed, other select measures are outlined in AU section 380, The Auditor’s Commu-
nication With Those Charged With Governance (AICPA, Professional Standards, vol. 1), that are specifically relevant
during an economic crisis and when measuring fair value. AU section 380 establishes standards and provides
guidance on the auditor’s communication with those charged with governance. As noted in paragraph .05 of
AU section 380, the auditor must communicate with those charged with governance matters related to the
financial statement audit that are, in the auditor’s professional judgment, significant and relevant to the
responsibilities of those charged with governance in overseeing the financial reporting process. The auditor
should communicate his or her views about the quality of the entity’s significant accounting policies,
accounting estimates, and financial statement disclosures.

.126 AU section 341 expands on the applicability of AU section 380 when the auditor has concluded that
substantial doubt exists about the entity’s ability to continue as a going concern. In that case, the auditor
should communicate to those charged with governance the nature of the events or conditions identified, the
possible effect on the financial statements, the sufficiency of the related disclosures, and the effects on the
auditor’s report.

Communicating Internal Control Related Matters Identified in an Audit

.127 In October 2008, the AICPA Auditing Standards Board (ASB) issued SAS No. 115, Communicating
Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, vol. 1, AU sec. 325). SAS
No. 115 amends SAS No. 112 and further clarifies standards and provides guidance on communicating matters
related to an entity’s internal control over financial reporting (internal control) identified in an audit of
financial statements.

.128 The new SAS is applicable whenever an auditor expresses an opinion on financial statements
(including a disclaimer of opinion) except when the auditor is performing an integrated audit and will be
expressing an opinion on the effectiveness of internal control over financial reporting under AT section 501,
An Examination of an Entity’s Internal Control Over Financial Reporting That Is Integrated With an Audit of Its
Financial Statements (AICPA, Professional Standards, vol. 1). This new standard is effective for audits of financial
statements for periods ending on or after December 15, 2009.

.129 In general, SAS No. 115 retains many of the provisions of SAS No. 112: it provides guidance to (a)
enhance the auditor’s ability to identify and evaluate deficiencies in internal control during an audit, and then
(b) communicate to management and those charged with governance those deficiencies that the auditor
believes are significant deficiencies or material weaknesses.

.130 The key differences between SAS No. 115 and SAS No. 112 lie in the definitions of material weaknesses
and significant deficiencies. Under SAS No. 112, the auditor applied criteria of likelihood and magnitude
described in that standard to determine if a control deficiency reached the threshold of significant deficiency
or material weakness. Under SAS No. 115, the same criteria are used; however, more judgment is allowed for
in determining whether a control deficiency is a significant deficiency.
Definitions of Significant Deficiency and Material Weakness

.131 A material weakness is a deficiency, or combination of deficiencies, in internal control, such that a reasonable possibility exists that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis. For the purpose of this definition, a reasonable possibility exists when the likelihood of the event is either reasonably possible or probable because those terms are used in FASB Statement No. 5, Accounting for Contingencies.2

.132 A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

The Evaluation Process

.133 Although the auditor is not required to perform procedures specifically to identify deficiencies in internal control, during the course of the audit, the auditor may become aware of deficiencies in the design or operation of the entity’s internal control. The auditor should evaluate the severity of each deficiency in internal control identified during the audit and determine whether the deficiency, individually or in combination with other deficiencies in internal control, rise to the level of significant deficiencies or material weaknesses. The severity of a deficiency in internal control depends on

- the magnitude of the potential misstatement resulting from the deficiency or deficiencies; and
- whether a reasonable possibility exists that the entity’s controls will fail to prevent or to detect and correct a misstatement of an account balance or disclosure.

.134 The severity of a deficiency does not depend on whether a misstatement actually occurred. If the auditor identifies a deficiency in internal control but has not identified an actual misstatement related to that deficiency, the auditor cannot automatically conclude that the deficiency is not a significant deficiency or a material weakness. If a misstatement has been identified, the auditor should consider the potential for further misstatement in the financial statements being audited.

.135 The AICPA published Audit Risk Alert Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115 (product no. 022539kk) to assist in understanding the requirements of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Accounting Issues and Developments

.136 Given the current economic crisis, auditors should consider a number of accounting and financial reporting issues, such as the following:

- Fair value, including fair value measurements in illiquid markets
- Impairment
- Liquidity restrictions

---

2 The term reasonably possible as used in the definition of the term material weakness has the same meaning as defined in Financial Accounting Standards Board (FASB) Statement No. 5, Accounting for Contingencies. Paragraph 3 of FASB Statement No. 5 states when a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms probable, reasonably possible, and remote to identify three areas within that range, as follows:

a. Probable. The future event or events are likely to occur.

b. Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.

c. Remote. The chance of the future event or events occurring is slight.

Therefore, the likelihood of an event is a reasonable possibility when it is reasonably possible or probable.

3 At the time of this writing, the FASB Accounting Standards Codification™ (ASC) had not yet been issued as authoritative. When the FASB ASC is issued as authoritative, the definitions currently found in FASB Statement No. 5 will be located at FASB ASC 450-20-25-1.
Fair Value

.137 Among the causes cited for the economic crisis, FASB Statement No. 157 has received a great deal of attention. FASB Statement No. 157 defines fair value and establishes a framework for measuring fair value; however, it does not dictate when an entity must measure something at fair value, nor does it expand the use of fair value in any way. The need to understand fair value accounting has increased in importance as alternative investments increased in popularity and complexity.

.138 FASB Statement No. 157 defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” A contention with FASB Statement No. 157 is the lack of guidance in applying fair value in an illiquid or distressed market, such as the current one. A lack of guidance also has the potential to allow inconsistencies in application by accountants and auditors. The areas of FASB Statement No. 157 that relate to measuring fair value in an illiquid market are limited to the following mentions in paragraphs 7, 10, and 17:

• “An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).”

• “Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are... [w]illing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so.”

• “For example, a transaction price might not represent the fair value of an asset or liability at initial recognition if... [t]he transaction occurs under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.”

.139 Both the SEC and FASB took notice of constituents’ desire for further guidance. In September 2008, the SEC issued SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting (SEC and FASB press release) to provide immediate clarifications on fair value in illiquid markets for preparers and auditors until FASB was able to provide additional interpretative guidance.

Determining Whether a Market Is Not Active and a Transaction Is Not Distressed

.140 On April 9, 2009, FASB issued FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly. The purpose of this FSP is to provide additional guidance in the application of FASB Statement No. 157; it supersedes FSP FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active. Among other points, the FSP

• affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions (that is, in the inactive market).

• clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active.

• eliminates the proposed presumption that all transactions are distressed (not orderly) unless proven otherwise. The FSP will instead require an entity to base its conclusion about whether a transaction was not orderly on the weight of the evidence.

• includes an example that provides additional explanation on estimating fair value when the market activity for an asset has declined significantly.

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4 At the date of this writing, this guidance has not yet been included in FASB ASC. Readers are encouraged to visit the FASB ASC Web site at http://asc.fasb.org/home and monitor codification updates.
• requires an entity to disclose a change in valuation technique (and the related inputs) resulting from the application of the FSP and to quantify its effects, if practicable, by major category.

• applies to all fair value measurements when appropriate.

.141 This FSP shall be effective for interim and annual reporting periods ending after June 15, 2009, and shall be applied prospectively. Early adoption is permitted for periods ending after March 15, 2009. Earlier adoption for periods ending before March 15, 2009, is not permitted. If a reporting entity elects to adopt early either FSP FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments, or FSP FAS 107-1 and Accounting Principles Board (APB) Opinion No. 28-1, Interim Disclosures about Fair Value of Financial Instruments, the reporting entity also is required to adopt early this FSP. Additionally, if the reporting entity elects to adopt this FSP early, FSP FAS 115-2 and FAS 124-2 also must be early adopted. This FSP does not require disclosures for earlier periods presented for comparative purposes at initial adoption. In periods after initial adoption, this FSP requires comparative disclosures only for periods ending after initial adoption.

Interim Disclosures About Fair Value of Financial Instruments

.142 On April 9, 2009, FASB released FSP FAS 107-1 and APB Opinion No. 28-1. This FSP relates to fair value disclosures for any financial instruments that are not currently reflected on the balance sheet of companies at fair value. Prior to issuing this FSP, fair values for these assets and liabilities were disclosed only once a year. The FSP requires these disclosures to be made on a quarterly basis, providing qualitative and quantitative information about fair value estimates for all those financial instruments not measured on the balance sheet at fair value. The FSP

• applies to all financial instruments within the scope of FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments.

• applies only to the financial statements of issuers for interim and annual reporting periods.

• requires an entity to disclose the methods and significant assumptions used to estimate the fair value of financial instruments and shall describe changes in methods and significant assumptions, if any, during the period.

.143 This FSP shall be effective for interim reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. An entity may adopt early this FSP only if it also elects to adopt early FSP FAS 157-4 and FSP FAS 115-2, and FAS 124-2. This FSP does not require disclosures for earlier periods presented for comparative purposes at initial adoption. In periods after initial adoption, this FSP requires comparative disclosures only for periods ending after initial adoption.

International Accounting Standards Board Fair Value Guidance

.144 In October 2008, the International Accounting Standards Board (IASB) issued the staff summary, “Using judgment to measure the fair value of financial instruments when markets are no longer active,” which accompanies the IASB expert advisory panel report “Measuring and disclosing the fair value of financial instruments in markets that are no longer active.” The summary takes into consideration and is consistent with FSP FAS 157-3 and the SEC and FASB press release. Additionally, the summary notes the consistency between FSP FAS 157-3 and the SEC and FASB press release with International Accounting Standard (IAS) No. 39, Financial Instruments: Recognition and Measurement.

AICPA Guidance on Applying FASB Statement No. 157 to Alternative Investments

.145 The Accounting Standards Executive Committee (AcSEC) of the AICPA has issued a draft issues paper, FASB Statement No. 157 Valuation Considerations for Interests in Alternative Investments. The draft issues paper discusses how to estimate the fair value of alternative investments (such as interests in hedge funds,

\[5\] See footnote 4.

\[6\] See footnote 4.
private equity funds, or real estate funds) in accordance with the provisions of FASB Statement No. 157. Among other things, the draft issues paper discusses the role of net asset value (NAV) in estimating fair value. Information about the status of this issues paper and the full text of the draft issues paper can be found at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/AcSEC+Issues+Draft+Issues+Paper+on+Valuation+of+Interests+in+Alternative+Investments.htm. Readers should be alert for the issuance of the final version of the paper.

**Liquidity Restrictions**

.146 As discussed in the “Audit and Attestation Issues and Developments” section of this alert, TIS section 1100.15 addresses the potential accounting and auditing implications when a fund or its trustee imposes restrictions on a nongovernmental entity’s ability to withdraw its balance in a money market fund or other short term investment vehicle.

**FASB Accounting Standards Codification™**

.147 FASB is expected to issue FASB ASC as authoritative effective July 1, 2009, at which time it will become the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. FASB ASC will supersede all then-existing, non-SEC accounting and reporting standards for nongovernmental entities. Once effective, all other nongrandfathered, non-SEC accounting literature not included in FASB ASC will become nonauthoritative. This change will affect accountants and auditors alike.

.148 FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing all authoritative literature in a topically organized structure. FASB ASC disassembled and reassembled thousands of nongovernmental accounting pronouncements (including those of FASB, the Emerging Issues Task Force [EITF], and the AICPA) to organize them under approximately 90 topics. FASB ASC includes all accounting standards issued by a standard setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, EITF, AICPA, and related literature. FASB ASC also includes relevant portions of authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance issued by the SEC; however, FASB ASC is not the official source of SEC guidance and does not contain the entire population of SEC rules, regulations, interpretive releases, and staff guidance.

.149 FASB ASC is not intended to change U.S. GAAP or any requirements of the SEC; rather, it is part of FASB’s efforts to reduce the complexity of accounting standards and also to facilitate international convergence. Moreover, FASB ASC does not include governmental accounting standards. The purposes behind the codification project include the following:

- Reduce the amount of time and effort required to solve an accounting research issue
- Mitigate the risk of noncompliance with standards through improved usability of the literature
- Provide accurate information with real-time updates as new standards are released
- Assist FASB with the research and convergence efforts required during the standard setting process
- Become the authoritative source of literature for the completed eXtensible Business Reporting Language (XBRL) taxonomy
- Clarify that guidance not contained in FASB ASC is not considered authoritative

.150 After the effective date of FASB ASC, FASB will no longer consider new standards authoritative in their own right. Instead, new standards will serve only to update FASB ASC and provide the historical basis for conclusions of a new standard.

.151 FASB ASC uses a topical structure in which guidance is organized into areas, topics, subtopics, sections, and subsections. These terms are defined as follows:
Areas are the broadest category in FASB ASC and represent a grouping of topics.

Topics are the broadest categorization of related content and correlate with the IASs and IFRS.

Subtopics represent subsets of a topic and are generally distinguished by type or scope.

Sections indicate the nature of the content, such as recognition, measurement, or disclosure. The sections’ structure correlates with the IASs and IFRS.

Subsections allow further segregation and navigation of content.

Topics, subtopics, and sections are numerically referenced. This effectively organizes the content without regard to the original standard setter or standard from which the content was derived. An example of the numerical referencing is FASB ASC 305-10-05, in which 305 is the Cash and Cash Equivalents topic, 10 represents the “Overall” subtopic, and 05 represents the “Overview and Background” section. Constituents are encouraged to begin using FASB ASC, which can be accessed at http://asc.fasb.org/home. GAAP specific to NFPs can be found at FASB ASC 958, Not-for-Profit Entities.

The AICPA has published Financial Reporting Alert FASB Codification Developments—2008 (product no. 029209kk). This Financial Reporting Alert is intended to provide a better understanding of FASB ASC, outline its structure, and provide case studies on navigating the FASB ASC Research System and performing accounting research.

Convergence With International Financial Reporting Standards

Since the signing of the Norwalk Agreement by FASB and the IASB, the bodies have had a common goal—one set of accounting standards for international use. In this agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB have undertaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and International Financial Reporting Standards (IFRS). These ongoing joint projects address the conceptual framework, business combinations, financial statement presentation, and revenue recognition. The “On the Horizon” section of this alert discusses these joint projects. For more information, visit www.fasb.org and www.iasb.org.

AICPA Launches IFRS.com Web Site

To assist in both awareness building and education, the AICPA launched the new Web site www.ifrs.com in May 2008. The site provides current information about developments in international convergence. Developed by the AICPA, in partnership with its marketing and technology subsidiary CPA2Biz, www.ifrs.com provides a comprehensive set of resources for accounting professionals, auditors, financial managers, audit committees, and other users of financial statements.

The Web site features tools and resources to help CPAs get acquainted with IFRS, the surrounding issues, and available support. Resources include a history of convergence, a high level overview of the differences between IFRS and U.S. GAAP, frequently asked questions, articles, textbooks, CPE courses and live conference training, helpful links, and assistance for audit committee members.

Accounting for Losses Due to Fraud

A topic of discussion for management and their auditors is the manner in which losses due to fraud are reflected in the financial statements. Because no accounting standard exists that provides specific guidance on accounting for losses due to fraud, application of professional judgment in this matter can lead to different results. For example, some clients have determined that the losses should be reported in the current period, when the entity became aware of the fraud, whereas others are opting for a restatement of the financial statements for one or more prior periods because they believe the loss in value occurred in a prior period and,
therefore, an adjustment is appropriate. It is important that the auditor understand how the decision was reached, and that proper disclosure be made in the financial statements.

.158 Auditors may also consider whether management has properly disclosed or recognized any liability associated with the potential clawback of distributions received from the perpetrator of Ponzi schemes. In the case of Madoff Investment Securities, a possibility exists that the bankruptcy trustee may file lawsuits to recover funds distributed to investors prior to the discovery of the fraud for the purpose of redistributing the funds. Management, in conjunction with appropriate legal counsel, should determine the probability and result of such a lawsuit and disclose or accrue a potential liability as required by FASB ASC 450, Contingencies.

Recent Pronouncements

.159 AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. For information on pronouncements issued subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued accounting standards in the CPA Letter and the Journal of Accountancy.

Recent Auditing and Attestation Pronouncements and Related Guidance

.160 The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

<table>
<thead>
<tr>
<th>Recent Auditing and Attestation Pronouncements and Related Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue Date: February 2009</td>
</tr>
<tr>
<td>(Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])</td>
</tr>
<tr>
<td>This standard amends AU section 722 to accommodate reviews of interim financial information of nonissuers, including companies offering securities pursuant to Securities and Exchange Commission (SEC) Rule 144A or participating in private equity exchanges. It is effective for reviews of interim financial information for interim periods beginning after December 15, 2009. Earlier application is permitted.</td>
</tr>
<tr>
<td>Issue Date: October 2008</td>
</tr>
<tr>
<td>(Applicable to audits conducted in accordance with GAAS)</td>
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<tr>
<td>Replacing SAS No. 112, <em>Communicating Internal Control Related Matters Identified in an Audit</em> (AICPA, <em>Professional Standards</em>, vol. 1, AU sec. 325A), this standard defines the terms deficiency in internal control, significant deficiency, and material weakness; provides guidance on evaluating the severity of deficiencies in internal control identified in an audit of financial statements; and requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit. It is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.</td>
</tr>
<tr>
<td>Issue Date: October 2008</td>
</tr>
<tr>
<td>This statement establishes requirements and provides guidance that applies when a practitioner is engaged to perform an examination of the design and operating effectiveness of an entity’s internal control over financial reporting (examination of internal control) that is integrated with an audit of financial statements (integrated audit). This SSAE is effective for integrated audits for periods ending on or after December 15, 2008. Earlier implementation is permitted.</td>
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## Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Issue Date: April 2007 Revised Date: November 2008 (Interpretive publication)</td>
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<tr>
<td>Issue Date: March 2002 Revised Date: May 2008 (Interpretive publication)</td>
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<tr>
<th>Interpretation No. 19, “Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board,” of AU section 508 (AICPA, <em>Professional Standards</em>, vol. 1, AU sec. 9508 par. .93–.97)</th>
<th>This interpretation of AU section 508 addresses the application of AU section 508 in reporting on financial statements prepared in conformity with IFRS.</th>
</tr>
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<tr>
<td>Issue Date: May 2008 (Interpretive publication)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Interpretation No. 2, “Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board,” of AU section 534, <em>Reporting on Financial Statements Prepared for Use in Other Countries</em> (AICPA, <em>Professional Standards</em>, vol. 1, AU sec. 9534 par. .05–.08)</th>
<th>This interpretation of AU section 534 addresses the application of AU section 534 in reporting on financial statements prepared in conformity with IFRS.</th>
</tr>
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<tr>
<td>Issue Date: May 2008 (Interpretive publication)</td>
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<td>Issue Date: May 2008 (Interpretive publication)</td>
<td></td>
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</tbody>
</table>
### Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Interpretation No. 7, “Reporting on the Design of Internal Control,” of AT section 101, Attest Engagements (AICPA, Professional Standards, vol. 1, AT sec. 9101 par. 59–69)</th>
<th>This interpretation of AT section 101 addresses how a practitioner may report on the suitability of the design of an entity’s internal control over financial reporting for preventing or detecting and correcting material misstatements of the entity’s financial statements on a timely basis.</th>
</tr>
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<tbody>
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<td>Issue Date: December 2008 (Interpretive publication)</td>
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<tr>
<th>Technical Questions and Answers (TIS) section 1900.01, “Condensed Interim Financial Reporting by Nonissuers” (AICPA, Technical Practice Aids)</th>
<th>This question and answer indicates that when preparing condensed interim financial statements, nonissuers may analogize to the guidance in Article 10 of SEC Regulation S-X regarding form and content because Accounting Principles Board (APB) Opinion No. 28, Interim Financial Reporting, does not provide a reporting framework. APB Opinion No. 28 is codified primarily at Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 270, Interim Reporting.</th>
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<td>Issue Date: January 2009 (Nonauthoritative)</td>
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<tr>
<th>TIS section 9150.25, “Determining Whether Financial Statements Have Been Prepared by the Accountant” (AICPA, Technical Practice Aids)</th>
<th>This question and answer discusses what an accountant should consider in determining whether he or she has prepared the financial statements of a nonissuer.</th>
</tr>
</thead>
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<tr>
<td>Issue Date: December 2008 (Nonauthoritative)</td>
<td></td>
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</tbody>
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<tr>
<th>TIS section 1100.15, “Liquidity Restrictions” (AICPA, Technical Practice Aids)</th>
<th>This question and answer discusses auditing and accounting issues related to withdrawal restrictions placed on short-term investments by a money market fund or its trustee.</th>
</tr>
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<td>Issue Date: October 2008 (Nonauthoritative)</td>
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</tbody>
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<tr>
<th>TIS sections 8200.05–.16 (AICPA, Technical Practice Aids)</th>
<th>These questions and answers in TIS section 8200, Internal Control, were developed in response to common questions received from members regarding the implementation of SAS Nos. 104–111. Some of the topics include the following</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue Date: April and May 2008 (Nonauthoritative)</td>
<td></td>
</tr>
</tbody>
</table>

### (continued)
### Recent Auditing and Attestation Pronouncements and Related Guidance

Recent Auditing and Attestation Pronouncements and Related Guidance

TIS section 9120.08, “Part of an Audit Performed in Accordance With International Standards on Auditing” (AICPA, Technical Practice Aids)

Issue Date: April 2008

(Nonauthoritative)

This question and answer discusses the implications to the principal auditor’s report when part of an audit is conducted by other independent auditors in accordance with International Standards on Auditing or another country’s auditing standards.

### Recent Accounting Pronouncements and Related Guidance

.161 The following table presents a list of recently issued accounting pronouncements and related guidance.

<table>
<thead>
<tr>
<th>Recent Accounting Pronouncements and Related Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>FASB Statement No. 1627 (May 2008)</td>
</tr>
<tr>
<td>FASB Statement No. 161 (March 2008) (Codified at FASB ASC 815, Derivatives and Hedging)</td>
</tr>
<tr>
<td>FASB Statement No. 160 (December 2007) (Codified at FASB ASC 810, Consolidation)</td>
</tr>
<tr>
<td>FASB Statement No. 141 (revised 2007) (December 2007) (Codified at FASB ASC 805, Business Combinations)</td>
</tr>
<tr>
<td>FASB Staff Positions (FSPs) (Various dates)</td>
</tr>
</tbody>
</table>

7 See footnote 4.

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<table>
<thead>
<tr>
<th>Recent Accounting Pronouncements and Related Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue Date: March 2009 (Nonauthoritative)</td>
</tr>
<tr>
<td>This question and answer indicates that the disclosures required by paragraphs 32–34 of FASB Statement No. 157 are required for individual investments under a master trust arrangement and are not required for the plan’s total interest in the master trust.</td>
</tr>
<tr>
<td>TIS section 6995.02, “Evaluation of Capital Investments in Corporate Credit Unions for Other-Than-Temporary Impairment” (AICPA, Technical Practice Aids)</td>
</tr>
<tr>
<td>Issue Date: February 2009 (Nonauthoritative)</td>
</tr>
<tr>
<td>This question and answer highlights the authoritative literature that help a corporate credit union evaluate its membership capital shares and paid-in capital in the U.S. Central Federal Credit Union for other-than-temporary impairment charges at December 31, 2008.</td>
</tr>
<tr>
<td>TIS section 6995.01, “Financial Reporting Issues Related to Actions Taken by the National Credit Union Administration on January 28, 2009 in Connection with the Corporate Credit Union System and the National Credit Union Share Insurance Fund” (AICPA, Technical Practice Aids)</td>
</tr>
<tr>
<td>Issue Date: January 2009 (Nonauthoritative)</td>
</tr>
<tr>
<td>This question and answer presents alternative views regarding whether the actions of the National Credit Union Administration constitute a type 1 or type 2 subsequent event with regard to the valuation of a federally insured credit union’s NCUSIF deposit at December 31, 2008. Additionally, this question and answer presents alternative views on when and how the obligation for the insurance premium should be recognized for financial reporting purposes.</td>
</tr>
<tr>
<td>TIS section 6910.29, “Allocation of Unrealized Gain (Loss), Recognition of Carried Interest, and Clawback Obligations” (AICPA, Technical Practice Aids)</td>
</tr>
<tr>
<td>Issue Date: January 2009 (Nonauthoritative)</td>
</tr>
<tr>
<td>This question and answer discusses how cumulative unrealized gains (losses), carried interest, and clawback should be reflected in the equity balances of each class of shareholder or partner at the balance sheet date when preparing financial statements of an investment partnership, in accordance with U.S. generally accepted accounting principles, in which capital is reported by investor class. In particular, this question and answer asks if cumulative period-end unrealized gains and losses should be allocated as if realized in accordance with the partnership’s governing documents prior to the date, time, or event specified in the partnership agreement.</td>
</tr>
<tr>
<td>TIS section 1900.01, “Condensed Interim Financial Reporting by Nonissuers” (AICPA, Technical Practice Aids)</td>
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</tr>
<tr>
<td>TIS section 6300.36, “Prospective Unlocking” (AICPA, Technical Practice Aids)</td>
</tr>
<tr>
<td>Issue Date: December 2008 (Nonauthoritative)</td>
</tr>
<tr>
<td>This question and answer discusses when an insurance company may change its original policyholder benefit liability assumptions.</td>
</tr>
</tbody>
</table>

(continued)
Recent Accounting Pronouncements and Related Guidance

TIS section 1100.15, “Liquidity Restrictions” (AICPA, Technical Practice Aids)
Issue Date: October 2008
(Nonauthoritative)

This question and answer discusses auditing and accounting issues related to withdrawal restrictions placed on short-term investments by a money market fund or its trustee.

Recent AICPA Independence and Ethics Pronouncements

.162 Audit Risk Alert Independence and Ethics Developments—2008 (product no. 022479kk) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

On the Horizon

.163 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to NFPs or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.164 The following table lists the various standard setting bodies’ Web sites, through which information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.

<table>
<thead>
<tr>
<th>Standard-Setting Body</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>AICPA Auditing Standards Board</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/</a></td>
</tr>
<tr>
<td>Financial Accounting Standards Board</td>
<td><a href="http://www.fasb.org">www.fasb.org</a></td>
</tr>
<tr>
<td>Governmental Accounting Standards Board</td>
<td><a href="http://www.gasb.org">www.gasb.org</a></td>
</tr>
<tr>
<td>Professional Ethics Executive Committee</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/">www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/</a></td>
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</table>

Overhaul Project—AICPA Audit and Accounting Guide Not-for-Profit Entities

.165 The AICPA is continuing to make progress overhauling the AICPA Audit and Accounting Guide Not-for-Profit Entities, addressing numerous accounting, auditing, industry, and regulatory issues that have transpired since this guide was originally issued in 1996. During this project, the AICPA will continue to issue annual editions of the guide, updated to reflect recent audit and accounting pronouncements.
Auditing and Attestation Pipeline—Nonissuers

**Auditing Standards Board Clarity Project**

.166 In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the next two or three years, the ASB will be redrafting all of the existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU sections of the AICPA’s *Professional Standards*) to apply the clarity drafting conventions and converge with the International Standards on Auditing issued by the International Auditing and Assurance Standards Board (IAASB). The ASB proposes that, except to address current issues, all redrafted standards will become effective at the same time. Only those standards needing to address current issues would have earlier effective dates. The ASB believes that a single effective date will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. Currently, the date is expected to be for audits of financial statements for periods beginning no earlier than December 15, 2010. This date depends on satisfactory progress being made, and will be amended should that prove necessary. See the explanatory memorandum “Clariﬁcation and Convergence” and the discussion paper Improving the Clarity of ASB Standards at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm.

.167 Among those standards included in the clarity project that will have early effective dates is the proposed SAS, *Compliance Audits*, which will supersede SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), which, if approved in its current form, will be effective for periods ending after June 15, 2010. More information about this proposed SAS will be available in the Audit Risk Alert Government Audit Standards and Circular A-133 Audits—2009 (product no. 0224509kk).

**Exposure Draft to Revise Standards for Compilation and Review Engagements**

.168 The Accounting and Review Services Committee (ARSC) issued an exposure draft that would revise the standards for compilation and review engagements. The changes would affect the interplay between the standards and independence rules, permitting an accountant to issue a review report on financial statements when the accountant’s independence is impaired by performing nonattest services that were designed to improve the reliability of the client’s financial information.

.169 The draft includes a trio of proposed standards: Framework and Objectives for Performing and Reporting on Compilation and Review Engagements; Compilation of Financial Statements; and Review of Financial Statements. In drafting the proposed standards, the ARSC considered recommendations from the Private Company Practice Section (PCPS) Reliability Task Force. The ARSC and PCPS believe the proposed standards will respond to many concerns of smaller business owners, users of small business financial statements, and CPAs that serve smaller entities.

.170 The PCPS task force recommended that the ARSC consider revising its standards for situations in which an accountant’s independence is impaired in connection with the performance of a nonattest service relating to the design or operation of an aspect of internal control over financial reporting. These nonattest services help management prepare higher quality or more reliable financial statements.

.171 The proposed standards would also harmonize the AICPA’s review standard with the International Auditing and Assurance Standards Board’s (IAASB) review standard International Standard on Review Engagements (ISRE) No. 2400, *Engagements to Review Financial Statements*.

.172 Significant proposed changes to the Statements on Standards for Accounting and Review Services (SSARs) include the following:
• The introduction of new terms such as moderate assurance, review evidence, and review risk to the review literature to harmonize with international review standards.

• A discussion of materiality in the context of a review engagement.

• A requirement that an accountant establish an understanding with management regarding the services to be performed through a written communication, that is, an engagement letter.

• The establishment of enhanced documentation requirements for compilation and review engagements.

• Guidance for practitioners who are engaged to perform a compilation or review engagement when they have also been engaged to perform nonattest services. The guidance includes reporting requirements for instances in which the accountant’s independence is impaired due to the performance of these services.

• The ability for an accountant to include a general description in the accountant’s compilation report regarding the reason(s) for an independence impairment.

.173 The comment deadline is July 31, 2009. The proposed effective date is for compilations and reviews of financial statements for periods beginning on or after December 15, 2010. Early application would be permitted. For further information on this project, visit www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/ARSC+Reliability+Project.htm

Accounting Pipeline

NFP Merger and Acquisition Guidance

.174 At its February 2009 meeting, FASB completed its redeliberations of the October 2006 exposure drafts, Not-for-Profit Organizations: Mergers and Acquisitions, and Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition. The following conclusions are expected to be included in the final standard:

• The acquisition method should be required for acquisitions by NFPs and decided that acquisitions should be distinguished from mergers. The use of the carryover method of accounting for acquisitions by small NFPs is not permitted. Additionally, to be consistent with FASB Statement No. 141(R), Business Combinations, any noncontrolling interest in an acquiree should be measured at fair value.

• FASB decided that a merger is different from an acquisition and warrants a different accounting treatment. They agreed that the feature that serves to differentiate a merger from an acquisition is control. In a merger, the governing bodies of two or more NFPs cede control of those entities to create a new entity. In an acquisition, one entity obtains control over the net assets of another entity or business. FASB determined that the carryover method of accounting should be retained for mergers of NFPs.

• In relation to the subsequent measurement of goodwill, FASB decided that those NFPs that recognize acquired goodwill should apply the guidance in FASB Statement No. 142, Goodwill and Other Intangible Assets, for subsequent testing and impairment. In addition, the board eliminated the proposed qualitative impairment evaluation approach as a direct result of its decision to require those NFPs predominantly supported by contributions and returns on investments to charge an excess of liabilities assumed and consideration transferred over assets acquired to the statement of activities.

.175 FASB indicated that the final statement will apply to all NFPs for the first fiscal year beginning after December 15, 2009, with no delayed effective date for smaller NFPs. Early adoption of the final statement will be prohibited. At this time, publication of the final statement is expected in April 2009. Additional information is available at the FASB Web site, www.fasb.org.
FASB and IASB Memorandum of Understanding

.176 In September 2008, FASB and the IASB updated their Memorandum of Understanding (MoU), originally published in 2006, to reaffirm their respective commitments to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. In developing the original MoU, FASB and the IASB agreed on priorities and established milestones as part of a joint work program to develop new common standards that improve the financial information reported to investors. FASB and the IASB agreed that the goal of joint projects is to produce common, principles-based standards, subject to the required due process. In the MoU, the boards identified the following 11 convergence topics on which to focus:

- Business combinations
- Financial instruments
- Financial statement presentation
- Intangible assets
- Leases
- Liabilities and equity distinctions
- Revenue recognition
- Consolidations
- Derecognition
- Fair value measurement
- Postemployment benefits (including pensions)

.177 Both FASB and the IASB note that their individual and joint efforts are not limited to the preceding items, but they remain committed to the MoU. FASB and the IASB also have several other joint projects in process including the conceptual framework project, emissions trading schemes, insurance contracts, and income taxes.

.178 Readers also are encouraged to monitor developments on the AICPA’s Web site, www.ifrs.com, in addition to the FASB, IASB, and SEC Web sites. The growing acceptance of IFRS as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession.

Other Accounting Projects

.179 Additionally, FASB has the following projects underway:

- Going concern
- Subsequent events
- Credit crisis projects that include the following:
  - Measuring liabilities under FASB Statement No. 157
  - Embedded credit derivatives scope exceptions
  - Recoveries of other-than-temporary impairments
  - Improving disclosures about fair value measurements
  - Applying fair value to interests in alternative investments
- Phase 2 of the applicability of FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109, for private entities (FIN No. 48 is codified at FASB ASC 740, Income Taxes.)
• An amendment to FASB Statement No. 162, The Hierarchy of Generally Accepted Accounting Principles,8 and approval of FASB ASC
• Disclosure of certain loss contingencies
• Reconsideration of FIN No. 46(R), Consolidation of Variable Interest Entities (FIN No. 46 is codified primarily at FASB ASC 810, Consolidation.)
• Transfers of financial assets
• Loan loss disclosures
• Phase two of postretirement benefit obligations including pensions
• Deferred tax assets and liabilities on available-for-sale debt securities that are expected to be held to recovery
• Oil and gas disclosures
• Treatment of base jackpot liabilities of casinos

.180 FASB and the IASB established an advisory group, the Financial Crisis Advisory Group (FCAG), which is composed of senior leaders with international experience in financial markets. The FCAG will advise FASB and the IASB about the standard-setting implications of the global financial crisis as well as changes to the global regulatory environment. Readers should refer to http://fasb.org/fcag/index.shtml for additional information.

Resource Central

.181 The following are various resources that practitioners engaged in the NFP industry may find beneficial.

Publications

.182 Practitioners may find the following publications useful. Choose the format that is best for you—online, print, or CD-ROM.

• Audit and Accounting Guide Not-for-Profit Entities (2009) (product no. 012648kk [paperback], WNP-XXkk [online with the associated Audit Risk Alert], or DNP-XXkk [CD-ROM])
• Audit and Accounting Guide Government Auditing Standards and Circular A-133 Audits (2008) (product no. 012748kk [paperback], WRF-XXkk [online with the associated Audit Risk Alert], or DRF-XXkk [CD-ROM])
• Audit and Accounting Guide Healthcare Entities (2009) (product no. 012619kk [paperback], WHC-XXkk [online with the associated Audit Risk Alert], or DHC-XXkk [CD-ROM])
• Audit Guide Analytical Procedures (2008) (product no. 012558kk [paperback], WAN-XXkk [online], or DAN-XXkk [CD-ROM])
• Audit Guide Assessing and Responding to Audit Risk in a Financial Statement Audit (2006) (product no. 012456kk [paperback] or WRA-XXkk [online])
• Audit Guide Auditing Revenue in Certain Industries (2009) (product no. 012519kk [paperback], WARR-XXkk [online], or DAR-XXkk [CD-ROM])
• Audit Guide Audit Sampling (2008) (product no. 012538kk [paperback], WAS-XXkk [online], or DAS-XXkk [CD-ROM])
• Audit Guide Service Organizations: Applying SAS No. 70, as Amended (2009) (product no. 012779kk [paperback], WSV-XXkk [online], or DSV-XXkk [CD-ROM])

8 See footnote 4.
• Audit Risk Alert Comprehensive Audit Risk Alert—2008 (product no. 022339kk [paperback], WGE-XXkk [online], or DGE-XXkk [CD-ROM])

• Audit Risk Alert Current Economic Crisis: Accounting and Auditing Considerations—2009 (product no. 0223308kk [paperback], WGE-XXkk [online], or DGE-XXkk [CD-ROM])

• Audit Risk Alert Healthcare Industry Developments—2008 (product no. 022349kk [paperback], WHC-XXkk [online with the associated Audit and Accounting Guide], or DHC-XXkk [CD-ROM])

• Audit Risk Alert Government Audit Standards and Circular A-133 Audits—2008 (product no. 022458kk [paperback], WRF-XXkk [online with the associated Audit and Accounting Guide], or DRF-XXkk [CD-ROM])

• Audit Risk Alert Compilation and Review—2008 (product no. 022309kk [paperback], WCR-XXkk [online], or DCR-XXkk [CD-ROM])

• Audit Risk Alert Independence and Ethics Developments—2008 (product no. 022479kk [paperback], WIA-XXkk [online], or DIA-XXkk [CD-ROM])

• Checklists and Illustrative Financial Statements Not-for-Profit Entities (product no. 008989kk [paperback] or WNP-CLkk [online])

• Guide to Fraud in Governmental and Not-for-Profit Environments, Revised Edition (product no. 091032kk [paperback])

• Accounting Trends & Techniques, 62nd Edition (product no. 009900kk [paperback] or WAT-XXkk [online])

• Accounting Trends & Techniques—Not-for-Profit Organizations (2005) (product no. 006616kk)

• Audit and Accounting Manual (2008) (product no. 005138kk [paperback], WAM-XXkk [online], or AAM-XXkk [loose leaf])

• Audit and Accounting Practice Aid Independence Compliance: Checklists and Tools for Complying With AICPA and GAO Independence Standards (product no. 006611kk [paperback])

.183 Additional resources for accountants in business and industry are the Financial Reporting Alert series, designed to be used by members of an entity’s financial management and audit committee to identify and understand current accounting and regulatory developments affecting the entity’s financial reporting.


• Financial Reporting Alert FASB Codification Developments—2008 (product no. 029209kk [paperback])

• Financial Reporting Alert Not-for-Profit Organizations: Accounting Issues and Risks—2008 (product no. 029207kk [paperback])

AICPA reSOURCE: Accounting and Auditing Literature

.184 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm’s needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to the AICPA’s latest Professional Standards, Technical Practice Aids, Audit and Accounting Guides, Audit Risk Alerts, Accounting Trends & Techniques, and more. To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.
Continuing Professional Education

.185 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- **AICPA’s Annual Accounting and Auditing Update Workshop (2008–2009 Edition)** (product no. 736184kk [text] or 187192kk [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.

- **The International Financial Reporting Standards: An Overview** (product no. 157220kk [online] or 739750HSkk [CD-ROM]). This course captures a live presentation on IFRS given to the AICPA board of directors.

.186 Among the many courses, the following are specifically related to the NFP industry:

- **Auditing Nonprofits: Tips and Traps** (product no. 731525kk [text]). This course will help you better understand essential aspects of auditing in this industry to conduct audits in the most effective manner and offer practical tips to guide you through possible traps encountered in auditing a not-for-profit.

- **Nonprofit Auditing and Accounting Update (2008–2009 Edition)** (product no. 732094kk [text] or 182075kk [DVD]). Covering all the latest auditing and accounting developments affecting not-for-profit entities, this course will give you a complete understanding of changes in the not-for-profit environment. For 2008–2009, the course will include coverage of the new Yellow Book, SAS No. 112, and more.

- **Accounting and Reporting Practices of Not-for-Profit Organizations** (product no. 743276kk [text]). Understand and apply the requirements of FASB and AICPA pronouncements to your not-for-profit clients. Consider real world financial statements, cases, and problems faced by CPAs with not-for-profit clients and by executives of NFPs.

- **Frequent Frauds Found in Governments and Not-For-Profits** (product no. 733311kk [text]). Through an informative case study approach, this course illustrates common frauds that make headlines and damage the reputations of government and NFPs.

.187 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.188 AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA’s flagship online learning product. AICPA members pay $180 for a new subscription and $149 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to NFPs include the following:

- **Nonprofit Auditing: Unique Auditing for a Unique Entity**

- **Fraud in Exempt Organizations: The Governmental and Not-for-Profit Environments**

- **Nonprofit Accounting: Financial Reporting**

.189 To register or learn more, visit www.cpa2biz.com.

Webcasts

.190 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession’s leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.
CFO Quarterly Roundtable Series

.191 The CFO Quarterly Roundtable Series, brought to you each calendar quarter via webcast, covers a broad array of “hot topics” that successful entities employ and subjects that are important to the CFO’s personal success. From financial reporting, budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

IFRS Quarterly Webcast Series

.192 The IFRS Quarterly Webcast Series, brought to you each calendar quarter, is part of a multistep educational process to get practitioners, financial managers, and auditors up to speed on all aspects of IFRS implementation. Over the course of the quarterly series, IFRS standards will be covered in depth. International harmonization is quickly approaching, and this series will help both accountants and auditors stay abreast of the developments and the changes they will need to implement.

Member Service Center

.193 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.194 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA’s Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/.

Ethics Hotline

.195 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

Industry Conferences

.196 The AICPA offers its annual not-for-profit entities conference in June. The National Not-For-Profit Industry Conference is a comprehensive forum that deals with the challenges facing not-for-profit practitioners and financial executives today. It’s where you’ll find out the latest information on the impact of tax, management, auditing, and accounting issues pertaining to NFPs. You’ll also receive training in operational strategies that are crucial to the well-being of an NFP. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

.197 In November, the AICPA offers its Not-for-Profit Financial Executive Forum in Anaheim, CA. This conference is a unique educational offering focusing on the issues faced by financial executives in NFPs. The objective of the forum is to provide a solutions-based conference that will address a wide variety of relevant topics encountered by the NFP financial executive. The sessions offered will enable increased interaction and the exchange of ideas among the participants and seek to provide clarification on the tough subjects. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.
AICPA Governmental Audit Quality Center

.198 The Governmental Audit Quality Center (GAQC) is a firm-based, voluntary membership center designed to help CPAs meet the challenges of performing quality audits in this unique and complex area. The GAQC’s primary purpose is to promote the importance of quality governmental audits and the value of such audits to purchasers of governmental audit services. The GAQC also offers resources to enhance the quality of a firm’s governmental audits.

.199 The mission of the GAQC is to do the following:

• Raise awareness about the importance of governmental audits
• Serve as a comprehensive resource provider on governmental audits for member firms
• Create a community of firms that demonstrates a commitment to governmental audit quality
• Provide center members with an online forum tool for sharing best practices and discussing audit, accounting, and regulatory issues
• List member firms to enable purchasers of governmental audit services to identify firms that are members
• Provide information about the center’s activities to other governmental audit stakeholders

.200 For more information about the GAQC, visit gaqc.aicpa.org.

AICPA Industry Expert Panel—Not-for-Profit Entities

.201 For information about the activities of the AICPA Not-for-Profit Entities Industry Expert Panel, visit the panel’s Web page at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_notforprofit.htm.

Industry Web Sites

.202 The Internet covers a vast amount of information that may be valuable to auditors of NFPs, including current industry trends and developments. Some of the more relevant sites for auditors with not-for-profit clients include those shown in the appendix of this alert.

.203 The Not-for-Profit industry practices of some of the larger CPA firms also may contain industry-specific auditing and accounting information that is helpful to auditors.

* * * *

.204 This Audit Risk Alert replaces Not-for-Profit Organizations Industry Developments—2008.

.205 The Audit Risk Alert Not-for-Profit Entities Industry Developments is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year’s Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to ccole@aicpa.org or write to

Christopher Cole
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110
## Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

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<tr>
<th><strong>Web Site Name</strong></th>
<th><strong>Content</strong></th>
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</table>
| American Institute of CPAs (AICPA) | Summaries of recent auditing and other professional standards as well as other AICPA activities | www.aicpa.org  
  www.cpa2biz.com  
  www.ifrs.com |
| AICPA Accounting Standards Executive Committee (AcSEC) | Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things | www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards |
| AICPA Accounting and Review Services Committee (ARSC) | Summaries of review and compilation standards and interpretations | www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+Review+Services+Committee |
| AICPA Professional Issues Task Force (PITF) | Summaries of practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts | www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force |
| Better Business Bureau | Information about NFPs and donors | www.give.org |
| Board Source | Resources to help strengthen NFP boards of directors | www.boardsource.org |
| The Chronicle of Philanthropy | Articles from the Chronicle of Philanthropy newspaper and links to other sites | www.philanthropy.com |
| CompassPoint Nonprofit Services | Workshops, consulting, publications, and other information and resources of interest to managers of NFPs | www.compasspoint.org |
| CPA.net | Links to other Web sites of interest to CPAs | www.cpanet.com |
| Economy.com | Source for analyses, data, forecasts, and information on the United States and world economies | www.economy.com |
| The Federal Reserve Board | Source of key interest rates | www.federalreserve.gov |
| Financial Accounting Standards Board (FASB) | Summaries of recent accounting pronouncements and other FASB activities | www.fasb.org |

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<thead>
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<td>Governmental Accounting Standards Board (GASB)</td>
<td>Summaries of recent accounting pronouncements and other GASB activities</td>
<td><a href="http://www.gasb.org">www.gasb.org</a></td>
</tr>
<tr>
<td>Guidestar</td>
<td>Information, news, and resources for NFPs and donors</td>
<td><a href="http://www.guidestar.org">www.guidestar.org</a></td>
</tr>
<tr>
<td>Independent Sector</td>
<td>A forum to encourage giving, volunteering, NFP initiatives, and citizen action</td>
<td><a href="http://www.independentsector.org">www.independentsector.org</a></td>
</tr>
<tr>
<td>Information for Tax-Exempt Organizations (an IRS site)</td>
<td>A Treasury Department site providing information and answers to frequently asked questions regarding tax-exempt entities</td>
<td><a href="http://www.irs.gov/charities/index.html">www.irs.gov/charities/index.html</a></td>
</tr>
<tr>
<td>International Accounting Standards Board (IASB)</td>
<td>Summaries of International Financial Reporting Standards and International Accounting Standards</td>
<td><a href="http://www.iasb.org">www.iasb.org</a></td>
</tr>
<tr>
<td>International Auditing and Assurance Standards Board (IAASB)</td>
<td>Summaries of International Standards on Auditing</td>
<td><a href="http://www.iaasb.org">www.iaasb.org</a></td>
</tr>
<tr>
<td>International Federation of Accountants (IFAC)</td>
<td>Information on standards setting activities in the international arena</td>
<td><a href="http://www.ifac.org">www.ifac.org</a></td>
</tr>
<tr>
<td>National Association of College and University Business Officers</td>
<td>Provides information geared to colleges and universities, including accounting tutorials on specific situations encountered in higher education accounting</td>
<td><a href="http://www.nacubo.org">www.nacubo.org</a></td>
</tr>
<tr>
<td>The National Center for Charitable Statistics</td>
<td>Provides statistics on revenue and expenses of NFPs</td>
<td><a href="http://www.nccs.urban.org">www.nccs.urban.org</a></td>
</tr>
<tr>
<td>The Nonprofit Risk Management Center</td>
<td>Provides information to help NFPs control their risks</td>
<td><a href="http://www.nonprofitrisk.org">www.nonprofitrisk.org</a></td>
</tr>
<tr>
<td>The Nonprofit Times Online</td>
<td>Articles from the Nonprofit Times newspaper and links to other sites</td>
<td><a href="http://www.nptimes.com">www.nptimes.com</a></td>
</tr>
<tr>
<td>Private Company Financial Reporting Committee (PCFRC)</td>
<td>Information on the initiative to further improve FASB’s standard setting process to consider needs of private companies and their constituents of financial reporting.</td>
<td><a href="http://www.pcfrc.org">www.pcfrc.org</a></td>
</tr>
<tr>
<td>USA.gov</td>
<td>Portal through which all government agencies can be accessed</td>
<td><a href="http://www.usa.gov">www.usa.gov</a></td>
</tr>
<tr>
<td>U.S. Office of Management and Budget</td>
<td>OMB information and literature including cost circulars</td>
<td><a href="http://www.whitehouse.gov/OMB">www.whitehouse.gov/OMB</a></td>
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AAM Section 8220

Government Auditing Standards and Circular A-133 Developments—2008

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL AND COMPLIANCE REPORTING

Notice to Readers

This Audit Risk Alert is intended to provide auditors who perform audits under Government Auditing Standards or Office of Management and Budget Circular A-133, Audits of States, Local Governments, and Nonprofit Organizations, with an overview of recent technical, regulatory, and professional developments that may affect the audits they perform.

This publication is an other auditing publication as defined in AU section 150, Generally Accepted Auditing Standards (AICPA, Professional Standards, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Susan M. Reed, CPA
Technical Manager
Accounting and Auditing Publications

Acknowledgments

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your audits conducted in accordance with Government Auditing Standards (GAS or the Yellow Book) or Office of Management and Budget (OMB) Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations (Circular A-133). This alert can also be used by an entity’s internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environment in which your clients operate. Moreover, this alert delivers information about emerging practice issues and current auditing and regulatory developments as it relates to audits performed under GAS and Circular A-133.
.02 It is important that you understand what is happening in the GAS and Circular A-133 arena if you perform these audits. This alert assists you in gaining an understanding of key developments regarding these audits.

.03 Readers may also find the *Comprehensive Audit Risk Alert—2008* (product no. 022339kk) useful. Further, if you are performing a financial statement audit of a state, local government, or nonprofit organization, you may also refer to the following Audit Risk Alerts:

- Audit Risk Alert *State and Local Governmental Developments—2008* (product no. 022438kk)
- Audit Risk Alert *Not-For-Profit Organizations Industry Developments—2008* (product no. 022428kk)
- Audit Risk Alert *Health Care Industry Developments—2008* (product no. 022349kk)

.04 These alerts can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in these alerts.

**Understanding the Entity, Its Federal Programs and Compliance Requirements, Internal Control Over Compliance and Assessing the Risks of Material Noncompliance**

.05 As noted in AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), an auditor should obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures. The Audit Risk Alerts titled, *State and Local Governmental Developments—2008*, *Not-For-Profit Organizations Industry Developments—2008*, and *Health Care Industry Developments—2008* further discuss the auditor’s responsibilities in this area for a financial statement audit.

.06 In a GAS or Circular A-133 audit, it is also important to understand the entity subject to audit, its federal programs and compliance requirements, and its internal control over compliance with those compliance requirements. This understanding assists the auditor in assessing the risk of material noncompliance and to design the nature, timing, and extent of further audit procedures.

.07 Further, Circular A-133 states that the auditee should maintain internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on each of its federal programs. The auditor should perform procedures to obtain an understanding of internal control over federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs. The auditor should understand the assertions relevant to the compliance requirements for each major program. When considering internal control over compliance, the auditor should obtain an understanding of the five elements of internal control (that is, control environment, risk assessment, control activities, information and communication, and monitoring) sufficient to assess the risks of material noncompliance with each direct and material compliance requirement for each major program.

.08 The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to the compliance audit and to determine whether they have been implemented. The auditor should use the information gathered from the risk assessment procedures as audit evidence to support the risk assessment.

.09 Risk assessment procedures are described in paragraph .06 of AU section 314 and may include inquiry of entity personnel, observing the application of a specific control, and inspecting documents and reports. Paragraph .55 of AU section 314 states that inquiry alone is not sufficient to evaluate the design of a control and to determine whether it has been implemented. Chapter 9, “Consideration of Internal Control
Over Compliance for Major Programs” of the Audit Guide Government Auditing Standards and Circular A-133 Audits provides more information related to the auditor’s consideration and testing of internal control over compliance for major programs.

.10 Because Circular A-133 requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major federal programs, the auditor should assess not only the risk that noncompliance may cause the financial statements to contain a material misstatement, but also the risk that noncompliance may have a material effect on each of its major programs. Chapter 6, “Planning Considerations of Circular A-133,” of the Audit Guide Government Auditing Standards and Circular A-133 Audits discusses audit risk as it relates to the compliance auditing of major programs.

.11 Finally, one of the auditor’s initial tasks in the planning process of a GAS or Circular A-133 audit is determining whether management has properly defined the entity to be audited. Chapter 6 of the Audit Guide Government Auditing Standards and Circular A-133 Audits provides additional information on defining the entity to be audited, including the option for auditees to meet the requirements of Circular A-133 through a series of audits that cover an auditee’s departments, agencies, and other organizational units that expended or otherwise administered federal awards during a fiscal year.

Economic Developments

The State of the Economy

.12 When planning and performing a financial statement audit, an auditor should understand the economic conditions facing the industry. Economic activities relating to factors such as interest rates, availability of credit, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on the entity’s financial statements being audited. The Audit Risk Alerts State and Local Governmental Developments—2008 (product no. 022437), Not-For-Profit Organizations Industry Developments—2008 (product no. 022428), and Health Care Industry Developments—2008 (product no. 022348) further discuss the state of the economy and the potential impact on financial statement audits of governmental, not-for-profit, and health care organizations.

.13 Although it may appear at first glance that the recent turmoil in the financial markets may not have a direct impact on entities receiving federal funds, that may not be the case. An entity’s overall operations may be affected, which in turn may lead to changes in the services provided by the entity, its administration of federal programs, and its related internal control over compliance. This information may be a consideration for the auditor in planning and performing a Circular A-133 audit when assessing the risks related to the audit.

Legislative and Regulatory Developments

Report on Single Audit Quality

.14 From the standpoint of the federal user, audits conducted under Circular A-133 are a key accountability mechanism for the expenditure of taxpayer dollars. Circular A-133 defines single audit as an audit that includes both the entity’s financial statements and federal awards. In June 2007, the results of a federal study on single audit quality were issued by the President’s Council on Integrity and Efficiency (PCIE) and Executive Council on Integrity and Efficiency. The Report on National Single Audit Sampling Project (the PCIE report), identifies single audit quality deficiencies and shows that improvements are needed. The types of audit quality issues identified in the PCIE report are also consistent with the types of issues found in peer reviews of firms doing single audits and in investigations performed by the AICPA Professional Ethics Division. Appendix A, “Common Deficiencies Identified in the PCIE Report,” summarizes the deficiencies identified in the report.
Consequently, as an auditor who performs single audits, you should review the PCIE report in detail to determine if the audit quality deficiencies cited in the report may affect the planning of your future engagements or your current audit methodologies and documentation practices. This report will have a significant impact on the requirements for and performance of single audits in the future; therefore, it is important for auditors to understand the issues.

The PCIE report proposes a three pronged approach for reducing the deficiencies found and improving the quality of single audits: (1) revise and improve single audit standards, criteria, and guidance; (2) establish minimum continuing professional education (CPE) as a prerequisite for auditors to be eligible to be able to conduct and continue to perform single audits; and (3) review and enhance the disciplinary processes to address unacceptable audits and for not meeting training and CPE requirements. The recommendations in the report are directed at various organizations, including OMB, other federal agencies, the AICPA, and other single audit stakeholders.

Response to the PCIE Report

The AICPA shares the commitment of the federal agencies involved in the project to improve the quality of single audits. The audits reviewed were submitted and accepted for the period April 1, 2003, through March 31, 2004; and the AICPA is hopeful that many endeavors over the last several years (for example, the launch of the Governmental Audit Quality Center [GAQC]) have already begun to address some of the issues raised in the PCIE report.

The AICPA, the GAQC Executive Committee, and GAQC staff are working closely with the federal government to address the PCIE report recommendations. During the course of the past year, since the report was issued, the AICPA and GAQC have taken significant action in response to the PCIE report.

GAQC Director Testifies at Senate Hearing on Single Audit Quality

On October 25, 2007, the director of the AICPA’s GAQC testified before the U.S. Senate Homeland Security and Governmental Affairs Committee’s Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security.

The purpose of the hearing, “Single Audits: Are They Helping to Safeguard Federal Funds?”, was to discuss the results of the PCIE report and the various roles that oversight organizations have in monitoring single audits to ensure federal funds are safeguarded. Other witnesses included representatives from OMB, Government Accountability Office (GAO), and the Department of Education, which coordinated administration of the PCIE report.

The AICPA testimony emphasized that single audits are important in helping safeguard taxpayer dollars, that poorly performed audits are always unacceptable, and that the AICPA will continue its ongoing efforts to enhance the quality of governmental audits. The testimony provided by the AICPA also noted steps AICPA took, on its own initiative, long before the PCIE report was released to improve audit quality, with a strong emphasis on the establishment of the GAQC, in addition to the steps that are being taken in response to the PCIE report. One of the steps taken in response to the report was to form task forces to examine the findings and recommendations for the AICPA, which is discussed in the next section.

The testimony also included views on the other non-AICPA recommendations in the PCIE report. Furthermore, it was noted that significant improvement in the quality of governmental audits will only occur when all the key single audit stakeholder groups—the auditing profession, the procurers of single audit services, and the federal agencies—are involved in the solution.
The other witnesses also expressed concerns about the quality of single audits and discussed thoughts on how the quality issues might be solved. The written testimony of all witnesses can be accessed via the U.S. Senate subcommittee’s Web site at http://hsgac.senate.gov.

**AICPA and GAQC Single Audit Quality Task Forces**

In response to the PCIE report, the AICPA has formed seven task forces to examine the PCIE report findings and recommendations for the AICPA as follows:

- Sampling and materiality issues in a single audit environment
- Internal control and compliance responsibilities in a single audit environment
- Schedule of Expenditures of Federal Awards (SEFA) reporting issues
- Reporting audit findings in a single audit
- Single audit training needs and CPE evaluation
- Practice monitoring
- Statement on Auditing Standards SAS No. 74 revisions

These task forces have met since October 2007 and are studying the relevant issues. The goal of the task forces is to develop solutions to the detailed findings in the PCIE report that will provide guidance for auditors. These task forces are working with the Auditing Standards Board (ASB), OMB, and other federal agencies as necessary to ensure that all relevant parties are involved. A short summary of the work of each task force follows. Visit the GAQC Web site (www.aicpa.org/GAQC) for further updates and new developments.

**Sampling and Materiality Issues in a Single Audit Environment.** The purpose of this task force is to respond to the audit quality issues in the PCIE report that relate to sampling and materiality. This task force is developing a new chapter for the Audit Guide Government Auditing Standards and Circular A-133 Audits to address the many sampling considerations in a single audit environment. It will work closely with the ASB to ensure that any guidance issued is consistent with current auditing standards, as well as the AICPA Audit Guide Audit Sampling. The current plan is for the new chapter to be added to the 2009 version of the Audit Guide Government Auditing Standards and Circular A-133 Audits.

**Internal Control Over Compliance and Compliance Responsibilities in a Single Audit Environment.** The purpose of this task force is to respond to the audit quality issues in the PCIE report that relate to the auditor’s responsibilities for internal control over compliance—both in gaining an understanding of internal control and for testing internal control—as well as for compliance testing. As a first step, changes were made to both chapter 9 and chapter 10, “Compliance Auditing Applicable to Major Programs,” of the Audit Guide Government Auditing Standards and Circular A-133 Audits to enhance the discussion of the auditor’s responsibilities for both internal control over compliance and compliance. Additionally, this task force is developing illustrative audit documentation to assist auditors in documenting their understanding of internal control over compliance and related testing of both internal control and compliance.

**SEFA Reporting Issues.** The purpose of this task force is to respond to the audit quality issues in the PCIE report that relate to the auditor’s reporting on the SEFA. As a first step, changes were made to chapter 7, “Schedule of Expenditures of Federal Awards,” of the Audit Guide Government Auditing Standards and Circular A-133 Audits to enhance the discussion of the auditor’s responsibilities for testing and reporting on the SEFA. Additionally, this task force is developing an illustrative audit program to assist auditors in documenting the procedures performed on the SEFA and an illustrative checklist to document that the SEFA contains all of the required elements.

**Reporting Audit Findings in a Single Audit.** The purpose of this task force is to respond to the audit quality issues in the PCIE report that relate to the auditor’s reporting of findings. The task force is examining issues related to when audit findings must be reported and the elements to include in presenting findings.
The task force is developing an illustrative findings template to assist auditors in documenting and evaluating their findings and ensuring that their finding write-ups include all required elements.

.30 Single Audit Training Needs and CPE Evaluation. The purpose of this task force is twofold; both objectives are necessary in light of the recommendation in the PCIE report proposing that OMB consider requiring 16–24 hours of single audit training as a prerequisite to performing single audits. The first objective is to develop appropriate best practice training curriculums for auditors performing single audits at various staff levels. The second objective is to evaluate current AICPA CPE offerings relating to single audits from a number of perspectives to ensure high-quality training is available. The task force has developed a white paper summarizing its recommendations relating to single audit training, which it has submitted to OMB for its consideration in determining whether to make a future change to Circular A-133 to add a single audit training requirement.

.31 Practice Monitoring. This task force is studying the results of the PCIE report to determine ways in which the peer review process can aid in enhancing the quality and performance of Circular A-133 audits by member firms. The task force is in the first phase of its work, having recently met with the various federal agencies that perform quality control reviews (QCRs) to help the AICPA better understand the QCR processes across federal agencies and to assist the inspectors general in better understanding the peer review process. The task force anticipates presenting specific recommendations for actions at the peer review board’s early 2009 meeting so that its recommendations can potentially be implemented in the performance of 2009 peer reviews.

.32 SAS No. 74 Revisions. This task force is considering what revisions are needed to SAS No. 74, Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance (AICPA, Professional Standards, vol. 1, AU sec. 801), as a result of the PCIE report. Because this project will result in a number of clarifications and enhancements to SAS No. 74, formal due process is required. An exposure draft is expected to be issued by the end of 2008, with a final standard to be issued in 2009. Upon issuance, any appropriate changes needed to the Audit Guide Government Auditing Standards and Circular A-133 Audits will be made as conforming changes.

GAO Developments

Single Audit Quality—GAO Study

.33 The GAO has also been asked by the same Senate subcommittee that initiated the hearing mentioned previously to do its own separate study of the single audit process. Although the GAO will certainly take into account the results of the PCIE report, its study, most likely, will be broader and will include looking at how the Single Audit Act Amendments of 1996 (Single Audit Act) and Circular A-133 are working and whether changes need to be made. The GAO testimony identified some of the questions it believes need to be considered in addition to the recommendations cited in the PCIE report. The following questions will be contemplated in this study:

- What types of simplified alternatives exist for meeting the accountability objectives of the Single Audit Act for the smallest audits and what would the appropriate cutoff be for a less complex audit requirement?
- Is the current federal oversight structure for single audits adequate and consistent across federal agencies?
- What alternative federal oversight structures could improve overall accountability and oversight in the single audit process?
- Are federal oversight processes adequate and are sufficient resources being dedicated to oversight of single audits?
- What role can the auditing profession play in increasing single audit quality?
- Do the specific requirements in the Single Audit Act and Circular A-133 need to be updated?
Additionally, as part of the study the GAO will also consider the actions taken by the AICPA and OMB since the issuance of the PCIE report. The GAO study is anticipated to be completed by the end of 2008 or sometime early in 2009.

**2007 Revision of GAS**

Auditors are reminded that the GAO issued a complete update to GAS in 2007, which superseded the previous 2003 version. The new Yellow Book is effective for financial audits and attestation engagements for audits of periods beginning on or after January 1, 2008. For performance audits, the standards are effective for audits beginning on or after January 1, 2008. Some of the more significant changes in the 2007 version are as follows:

- Added a new chapter on ethical principles
- Enhanced and clarified the requirements for an audit organization’s system of quality control by specifying the elements of quality that an organization’s policies and procedures collectively address
- Added a requirement that external audit organizations make their most recent peer review report publicly available
- Updated GAS based on recent developments in financial auditing and internal control
- Increased transparency surrounding reporting on restated financial statements
- Revised the performance auditing chapters

Last year’s Audit Risk Alert covered the major changes to GAS in more detail. The 2007 revision of GAS can be accessed at www.gao.gov/govaud/ybk01.htm.

**GAS: Implementation Tool**

The GAO issued a guidance document, Government Auditing Standards: Implementation Tool—Professional Requirements Tool for Use in Implementing Requirements Identified by “Must” and “Should” in the July 2007 Revision of Government Auditing Standards. The professional requirements tool lists the requirements for audit organizations and auditors included in the 2007 revision of GAS.

The tool is divided into four sections. The general requirements section contains entitywide requirements for the audit organization and is intended for use in addition to the specific sections for financial audits, attestation engagements, and performance audits, which contain engagement specific requirements for the auditors conducting the engagement. Audit organizations and auditors should also refer to the complete text of the 2007 revision of GAS to understand the context for those requirements along with related guidance.

The tool was prepared by the GAO’s GAS staff to facilitate audit organizations’ and auditors’ implementation of the standards and to assist auditors with documenting compliance with GAS. It does not represent additional standards or requirements. Instead, it helps auditors quickly identify standards requirements and make decisions about those standards applicable to their audits. The tool is available at www.gao.gov/new.items/d08210g.pdf. (Implementation Tool, GAO-08-210G, December 2007).

**Guidance on Complying With GAS and the Sarbanes-Oxley Act of 2002**

Certain companies subject to the Securities Exchange Act of 1934 may be required to have an audit conducted in accordance with standards issued by both the Public Company Accounting Oversight Board (PCAOB), as required by the Sarbanes-Oxley Act of 2002, and the Comptroller General of the U.S., as contained in GAS. Some examples include lending institutions that participate in federally sponsored loan programs such as housing and education. For such entities, auditors must meet the requirements of both sets of standards in conducting their work.
GAS may be used in conjunction with standards issued by the PCAOB, even though these standards are not incorporated by reference into GAS. GAO recognized that the use of PCAOB’s framework for assessing internal control deficiencies could result in inconsistencies in reporting on internal control under GAS. In order to facilitate reporting under both PCOAB and GAO standards, to ensure consistency of information included in the GAS report on internal control, and to assist auditors in complying with GAS, GAO issued guidance on this subject in December 2007, which can be accessed at www.gao.gov/govaud/gagaspcaob2007.pdf. This guidance provides that

- auditors should include in the GAS report on internal control any material weakness contained in the opinion of the effectiveness of the audited entity’s internal control over financial reporting that was prepared based on PCAOB’s Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”);
- auditors who prepare the GAS report using “material weaknesses” from the PCAOB opinion on the effectiveness of the company’s internal control over financial reporting should also include in their report any other control deficiencies that meet the definitions of “material weakness” or “significant deficiency” as defined in SAS No. 112, Communicating Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, vol. 1, AU sec. 325). Such reporting satisfies the requirements of paragraph 5.11 of GAS;
- auditors should, in the GAS report, clearly state that the PCAOB standards and definition were used, describe the scope of the work performed, and provide appropriate definitions of applicable PCAOB terminology if they elect to include in the GAS report material weaknesses based on the definition provided in PCAOB Auditing Standard No. 5; and
- auditors should comply with all other relevant GAS requirements related to reporting deficiencies in internal control.

Other GAO Developments

In March 2008, David Walker, comptroller general of the U.S. and head of GAO, resigned his position in order to accept the position of president and CEO of the newly established Peter G. Peterson Foundation. Gene Dodaro, GAO’s chief operating officer, is currently serving as acting comptroller general.

OMB Developments

OMB Response to PCIE Report

In response to the PCIE report, the OMB has formed eight work groups to examine the PCIE report findings and recommendations from a federal perspective. The work groups are focusing on the following:

- Revisions to A-133 and AICPA guidelines to report audit findings
- Revisions to A-133, the AICPA Audit Guide, and the OMB Compliance Supplement to document the required compliance testing
- Revisions to A-133 and AICPA guidelines for audit testing and sampling
- Revisions to A-133 to require single audit training (will include development of training curriculum)
- Review of suspension and debarment process and identification of alternative methods to address unacceptable audits
- Coordination with other single audit constituencies for sanctions and punitive actions for substandard audits
- Coordination with PCIE to issue uniform standards on QCRs
- The New and Improved Single Audit Process
The work of one or more of these task forces could result in proposed revisions in Circular A-133 over the course of the next year. Auditors should visit the GAQC Web site (www.aicpa.org/GAQC) for updates on future developments.

**OMB Single Audits and Private Information**

Auditors reporting under Circular A-133 should be aware that personal private information should not be included in audit findings in reports issued under Circular A-133. Findings that involve sensitive information (for example, Social Security numbers) should be summarized in a manner that ensures the requirements found in Circular A-133 section 510(b) are met. However, any detailed personal private information should be omitted from the finding write-up. Auditors should also consider the guidance in sections 5.39–.43 of GAS (2007 revision). If a federal agency wishes to follow up on a finding, the personal information necessary to be communicated can be done so in a subsequent, nonelectronic, private communication to the agency when requested.

**Circular A-133 Compliance Supplement Update**

The Circular A-133 Compliance Supplement, issued annually by OMB, is one of the most important pieces of guidance used by an auditor in a single audit. The supplement identifies the compliance requirements that the federal government expects to be considered as part of an audit required by the Single Audit Act. For the programs it includes, the Compliance Supplement provides a source of information for auditors to understand the federal program’s objectives, procedures, and compliance requirements relevant to the audit, as well as audit objectives and suggested audit procedures for determining compliance with these requirements. Programs not listed in the Compliance Supplement are addressed in part 7, “Guidance for Auditing Programs Not Included in This Compliance Supplement,” which instructs readers to use the types of compliance requirements contained in the Compliance Supplement as a guide to help identify the compliance requirements to test, and to determine the requirements governing the federal program. A review of the provisions of the auditee’s contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements will assist the auditor in determining the relevant compliance requirements and any other federal requirements.

**Help Desk**—The current year’s Compliance Supplement and two previous years’ versions are available at www.whitehouse.gov/omb/grants/grants_circulars.html.

OMB issued the 2008 Compliance Supplement in May 2008. The 2008 Compliance Supplement is effective for audits of fiscal years beginning after June 30, 2007, and supersedes the 2007 Compliance Supplement issued in March 2007. Appendix V of the supplement, “List of Changes for the 2008 Compliance Supplement,” is a key piece of information to help the auditor identify all of the changes OMB has made to the supplement. Because there are numerous changes to many programs listed, it is important for auditors to review the most current Compliance Supplement as part of audit planning.

The 2008 Compliance Supplement has been updated for the 2007 revision to Circular A-133 and other guidance, links, and references, as appropriate. The more significant changes in the 2008 Compliance Supplement include the following:

- Five new programs were added to part IV, “Agency Program Requirements.”
- Over 40 programs and 2 program clusters (Research & Development and Student Financial Assistance Programs) had significant changes through updates, corrections, or both, in part IV. A number of additional programs had minor changes made to them.
- Significant changes in content, mainly reflecting part IV revisions, were made to part II, “Matrix of Compliance Requirements.”
• Significant changes reflecting the language of Circular A-133 were made to part III, “Allowable Costs/Cost Principles.” Compliance requirement I, “Procurement and Suspension and Debarment,” was also updated.

• Updates were made to appendix VI, “Disaster Waivers and Special Provisions Affecting Single Audits,” as well.

**OMB Web Site and Federal Funding Accountability and Transparency Act**

.49 The OMB Web site at www.USASpending.gov (previously accessed at www.federalspending.gov) provides searchable data on federal grants, contracts, and other spending, allowing taxpayers to see where their federal dollars go and who spends it. The purpose of this Web site is to satisfy the provisions of the Federal Funding Accountability and Transparency Act, which became law in 2006. Users can search by contracts and grants, contractor names, congressional districts, and lawmakers. The data can be sorted by the various column headings and is downloadable. Though the site is still a work in progress, ultimately, OMB plans for agencies to send information directly to this site so it will be available in real time.

**Pending Revision of Federal Financial Report**

.50 OMB is consolidating and replacing four existing financial reporting forms (SF-269, SF-269A, SF-272, and SF-272A) with a single Federal Financial Report (FFR). The purpose of the FFR is to give recipients a standard format for reporting the financial status of their grants and cooperative agreements. Consistent with government-wide streamlining objectives, the FFR will result in the use of standard reporting dates for interim reports. Interim reports (quarterly, semiannual, or annual) will be for the periods ending March 31, June 30, September 30, and December 31, regardless of the grant budget period or project period dates. Interim quarterly and semi-annual reports will be due 30 days after the reporting period end date. Annual and final reports will be due 90 days after the reporting period end date. The termination date of the grant or project is the reporting period end date for purposes of the final report. The new FFR form (SF-425) is available on the OMB Web site at www.whitehouse.gov/omb/grants/grants_forms.html. The revised form will be phased into use by no later than October 1, 2009.

**Federal Audit Clearinghouse Developments**

.51 The Federal Audit Clearinghouse (FAC) operates on behalf of OMB. Its primary purposes are to

- collect single audit and program specific audit information and disseminate it to federal agencies and the public;
- support OMB oversight and assessment of federal award audit requirements;
- assist federal cognizant and oversight agencies in obtaining Circular A-133 data and reporting packages; and
- help auditors and auditees minimize the reporting burden of complying with Circular A-133 audit requirements.

.52 Auditees are responsible for submitting the required reporting package, which includes the audit reports and the data collection form (DCF or Form SF-SAC). Both the auditee and the auditor are responsible for completing certain portions of the DCF before it is submitted with the reporting package.

**Submissions of the 2008–2010 DCF**

.53 Beginning with 2008 fiscal year-end and forward, paper submissions of the DCF (or Form SF-SAC) will not be accepted. One may submit it only online. In addition, while currently you can find the 2008–2010 DCF on the FAC Web site, the link takes you to the Internet Data Entry System (IDES), where the DCF is accessed and submitted electronically. Due to the newly instituted requirement of electronic submission, preparers of the form may need to upgrade their computer capabilities. The instructions for the 2008–2010
DCF ("IDES 2008–2010 Instructions") contain an extensive amount of information about using IDES and submitting the form. They too are available on the FAC Web site under DCF.

.54 The submission method for the single audit reporting package (which includes the DCF) has also changed, with the entire reporting package being submitted online.

.55 A summary of the steps is as follows:

2. Complete the DCF (or Form SF-SAC).
3. Upload the single audit.
4. Certify the submission.
5. Submit the entire single audit reporting package online.

.56 Users may return to their submission multiple times using the same password and report ID. Also, the certifying officials for both the auditee and auditor are required to certify the submission prior to the package’s online submission as a single PDF file. Only one copy of the reporting package is required. (Note that each report ID corresponds to one single audit submission for one fiscal period.) Both the auditee and auditor will receive an e-mail confirming the receipt of the single audit reporting package.

Submission of DCF for Fiscal Years Ending Prior to 2008


Major Programs and the DCF

.58 Among the quality deficiencies discussed in the PCIE report, a matter that was noted in multiple instances was referred to as a “material reporting error.” This deficiency occurred when the Schedule of Findings and Questioned Costs incorrectly identified certain major programs as having been audited when, in fact, they were not audited in that year. This is considered a very serious error as it results in the auditor erroneously expressing a compliance opinion on one or more programs that were not audited. In addition, it has been noted that when filling out the DCF, sometimes the incorrect box is marked indicating a major program when in fact the program is not major.

.59 To assist auditors and organizations in avoiding this type of error, the FAC made revisions to both IDES and the frequently asked questions (FAQ). When a form is being completed using IDES, a pop-up message appears at certain points (including when an entry has been input into part III, item 9g) that states, “Caution! Programs indicated as major must agree with programs identified as major in the summary of auditor’s results and actually tested as major by the auditor.” Also, question 22 in the FAQ has been revised to indicate the same.

DCF and Reporting Package Submission Not Appropriate in Compliance Audits of For-Profits

.60 Some for-profit entities are required by granting agencies through either a grant clause or contract to have a Circular A-133 audit (or an audit that is very similar to a Circular A-133 audit). The FAC has asked that auditors remind their for-profit clients that must undergo such an audit that they are not to send the
DCF and the audit reporting package to the FAC. The package should be sent, however, to the requesting federal or state agency.

**Using the FAC Database**

.61 Auditors may find it worthwhile to investigate the FAC database. Instructions for its use are on the FAC Web site at http://harvester.census.gov/fac. The FAC expects that the major users of its database will be federal sponsoring agencies. A number of agencies report that they have found it useful, for example, to compare the results of their own programmatic audits with those Circular A-133 audits performed by independent auditors and filed on the database. FAC officials also point out that auditors can benefit from the database. For example, consider the following benefits:

- Auditors and their clients can check on the status of submissions.
- Auditors and their clients can ascertain the status of their subrecipients’ submissions.
- Auditors can perform overall analytical assessments of their organization’s audits to determine, for example, whether there are any problems with the two year look back rule and major program determination.
- Auditors can look at reports or findings related to programs they are auditing to supplement staff training.

**U.S. Department of Housing and Urban Development Update**

**U.S. Department of Housing and Urban Development Consolidated Audit Guide Revisions**

.62 The U.S. Department of Housing and Urban Development (HUD) continues its chapter by chapter update of the Consolidated Audit Guide for Audits of HUD Programs. The following table summarizes the changes issued at the time of this writing.

<table>
<thead>
<tr>
<th>Consolidated Audit Guide for Audits of HUD Programs Chapter</th>
<th>Date Change Was Issued</th>
<th>Change Effective for Audits With Fiscal Years Ending On or After</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter 3, “HUD Multifamily Housing Programs”</td>
<td>July 21, 2008</td>
<td>December 31, 2008</td>
</tr>
<tr>
<td>Chapter 4, “HUD Multifamily Hospital Program”</td>
<td>July 21, 2008</td>
<td>Effective upon issuance</td>
</tr>
</tbody>
</table>
Chapter 3 of the HUD audit guide *Consolidated Audit Guide for Audits of HUD Programs* is the most recent updated chapter released by HUD. It relates to audits of HUD multifamily housing programs (that is, those that do not fall under the requirements of Circular A-133) and becomes effective for audits of fiscal years ending on or after December 31, 2008. If you are performing an audit of a multifamily program that is subject to Circular A-133 (for example, a not-for-profit organization), keep in mind that the HUD audit guide *Consolidated Audit Guide for Audits of HUD Programs* reiterates that chapter 3 is not intended to be a program-specific audit guide for compliance with Circular A-133 requirements. Instead, it states that if the *Compliance Supplement* includes the program that is being audited, the guidance in the supplement is to be used.

If the *Compliance Supplement* does not include the program that is being audited, part 7 of the supplement provides guidance on how to identify the applicable compliance requirements to test. Paragraph 1d of part 7 states, “If there is any audit guidance issued by the federal agency’s Office of Inspector General (OIG), the auditor may wish to consider this guidance in identifying the program objectives, program procedures, and compliance requirements.” Chapter 3 of the HUD audit guide *Consolidated Audit Guide for Audits of HUD Programs* should be used only for that purpose.

Auditors should review the transmittals announcing the issuance of each of the revised chapters, including the transmittal for chapter 3, on the HUD OIG Web site at www.hud.gov/offices/oig/reports/auditguide/. Those transmittals provide a summary of the significant revisions made to each chapter. Please also note that HUD has updated the illustrative internal control reporting found in chapter 2 of the HUD audit guide *Consolidated Audit Guide for Audits of HUD Programs* for the terminology and definitions found in AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, Professional Standards, vol. 1). However, the internal control reports on HUD’s Web site have not yet been updated to reflect the impact of recently issued SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, Professional Standards, vol. 1, AU sec. 325), which supersedes SAS No. 112 of the same title. See the following section, “SAS No. 115 and Implications for Circular A-133 and Other Governmental Audits,” for more information.

The following chapters of the *Consolidated Audit Guide for Audits of HUD Programs* are under revision at the time of this writing:

- Chapter 1 “General Audit Guidance”
- Chapter 2 “Reporting Requirements and Sample Reports”

Auditors should periodically check HUD’s Web site at www.hud.gov/offices/oig/reports/auditguide/ to make certain that they identify and follow the relevant audit guidance. Use this Web link to be sure you access the latest version of the guide. Several other Web links permit you to download the entire guide, but that, unfortunately, may not include the latest chapter revisions.

The GAQC Web site will provide status updates on future HUD revisions to the HUD audit guide *Consolidated Audit Guide for Audits of HUD Programs* on the newly established HUD information page at http://gaqc.aicpa.org/Resources/.
HUD Proposes an Independent Public Accountant Roster

On February 6, 2008, HUD issued a proposed rule titled “Independent Public Accountant Roster” relating to certain audits performed under the HUD audit guide *Consolidated Audit Guide for Audits of HUD Programs* or audits of governments or not-for-profit organizations that receive HUD funding and are subject to a single audit. The proposed rule would have modified HUD’s existing regulations in 24 Code of Federal Regulations (CFR) part 5 to establish a roster of approved independent public accountants and public accounting firms (IPAs) that would be permitted to perform audits or related services on covered entities. The proposed rule would have also established eligibility, application, and removal procedures for IPAs listed on the IPA Roster. Firms would have to submit an application to HUD and, upon acceptance, agree to adhere to eligibility requirements. HUD then would have had the ability to remove auditors from the roster for various reasons, including failing to maintain compliance with eligibility requirements. Once removed, a firm would no longer be allowed to perform HUD audits. In a recent public meeting, HUD staff announced that they were holding the proposed rule in abeyance in deference to the audit quality efforts underway in response to the PCIE report (see preceding sections “AICPA and GAQC Single Audit Quality Task Forces” and “OMB Response to PCIE Report”). Upon completion of those efforts, HUD will evaluate whether the changes made meet HUD needs and determine whether there is a need to restart efforts relating to a roster.

Audit and Attestation Issues and Developments

Summary of Recent Auditing and Attestation Pronouncements and Related Guidance

Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. This alert is intended to be used in conjunction with the *Comprehensive Audit Risk Alert—2008* (product no. 022339kk); therefore, only pronouncements and related guidance of specific significance to GAS and Circular A-133 audits are summarized herein. You can also refer to the industry specific Audit Risk Alerts mentioned previously in this alert for further discussion of the financial statement audit implications of these standards.

For information on auditing and attestation standards issued subsequent to the writing of this alert, please refer to the AICPA Accounting and Auditing Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the *CPA Letter, Journal of Accountancy*, and in the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. The GAQC Web site at www.aicpa.org/GAQC is also a useful resource.

As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. The PCAOB establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at for information about its activities.
### Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Pronouncement</th>
<th>Relevance</th>
<th>Issue Date</th>
<th>Applicability</th>
</tr>
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<tbody>
<tr>
<td><strong>Statement on Auditing Standards (SAS) No. 115, Communicating Internal Control Related Matters Identified in an Audit</strong> (AICPA, Professional Standards, vol. 1, AU sec. 325)</td>
<td>Replacing SAS No. 112, Communicating Internal Control Related Matters Identified in an Audit, this standard defines the terms deficiency in internal control, significant deficiency, and material weakness; provides guidance on evaluating the severity of deficiencies in internal control identified in an audit of financial statements; and requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit. It is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.</td>
<td>October 2008</td>
<td>(Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])</td>
</tr>
<tr>
<td><strong>SAS No. 114, The Auditor’s Communication With Those Charged With Governance</strong> (AICPA, Professional Standards, vol. 1, AU sec. 380)</td>
<td>This standard replaces SAS No. 61, Communication With Audit Committees. The standard requires the auditor to conduct two way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, who they should be communicated to, and the form and timing of the communication. It is effective for audits of financial statements for periods beginning on or after December 15, 2006.</td>
<td>December 2006</td>
<td>(Applicable to audits conducted in accordance with GAAS)</td>
</tr>
</tbody>
</table>
| **SAS No. 113, Omnibus Statement on Auditing Standards—2006** (AICPA, Professional Standards, vol. 1) | This standard does the following:  
- Revises the terminology used in the 10 standards of AU section 150, Generally Accepted Auditing Standards (AICPA, Professional Standards, vol. 1), to reflect terminology in AU section 120, Defining Professional Requirements in Statements on Auditing Standards (AICPA, Professional Standards, vol. 1).  
- Adds a footnote to the headings before paragraphs .35 and .46 in AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), to provide a clear link between the auditor’s consideration of fraud and the auditor’s assessment of risk, and the auditor’s procedures in response to those assessed risks.  
- Replaces throughout the auditing standards the term completion of fieldwork with the term date of the auditor’s report.  
- Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor’s report. | November 2006 | (Applicable to audits conducted in accordance with GAAS) |
| **SAS Nos. 104–111, the “Risk Assessment Standards”** | The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits; focusing on identifying and assessing the risks of material misstatements; further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels; and improving the linkage between the risks, controls, audit procedures, and conclusions. These eight SASs became effective for audits of financial statements for periods beginning on or after December 15, 2006. | March 2006 | (Applicable to audits conducted in accordance with GAAS) |

(continued)
### Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>Statement on Standards for Attestation Engagements (SSAE) No. 15, <em>An Examination of an Entity’s Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements</em> (AICPA, Professional Standards, vol. 1, AT sec. 501)</th>
<th>This statement establishes requirements and provides guidance that applies when a practitioner is engaged to perform an examination of the design and operating effectiveness of an entity’s internal control over financial reporting (examination of internal control) that is integrated with an audit of financial statements (integrated audit). This SSAE is effective for integrated audits for periods ending on or after December 15, 2008. Earlier implementation is permitted.</th>
</tr>
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<tbody>
<tr>
<td>Issue Date: October 2008</td>
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<tr>
<td>SSAE No. 14, SSAE Hierarchy (AICPA, Professional Standards, vol. 1, AT sec. 50)</td>
<td>This standard identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in AT section 20, Defining Professional Requirements in Statements on Standards for Attestation Engagements (AICPA, Professional Standards, vol. 1). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.</td>
</tr>
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<td>Issue Date: November 2006</td>
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</table>
| TIS sections 8200.05–16 (AICPA, Technical Practice Aids) | These questions and answers in TIS section 8200, *Internal Control*, were developed in response to common questions received from members regarding the implementation of SAS Nos. 104–111. Some of the topics include:
- consideration of internal controls that are less formal or not documented by the client.
- whether the auditor may suggest improvements to a client’s internal control.
- assessing inherent risk in relation to the consideration of control risk.
- the frequency of walkthroughs that are used as the basis for the auditor’s understanding of internal control.
- considerations in obtaining an understanding of, evaluating, and documenting controls that the auditor believes are nonexistent or ineffective.
- assessing control risk at the maximum level.
- considerations for developing a substantive audit strategy. |
| Issue Date: April and May 2008 (Nonauthoritative) | |
| TIS section 9100.06, “The Effect of Obtaining the Management Representation Letter on Dating the Auditor’s Report” (AICPA, Technical Practice Aids) | This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor’s report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor’s report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations. |
| Issue Date: May 2007 (Nonauthoritative) | |
Recent Auditing and Attestation Pronouncements and Related Guidance

<table>
<thead>
<tr>
<th>TIS section 8350.01, “Current Year Audit Documentation Contained in the Permanent File” (AICPA, Technical Practice Aids)</th>
<th>This question and answer discusses whether the provisions of AU section 339, Audit Documentation (AICPA, Professional Standards, vol. 1), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that AU section 339 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year’s audit report.</th>
</tr>
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<tr>
<td>Issue Date: May 2007 (Nonauthoritative)</td>
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<tr>
<th>AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, Audit Confirmations (AICPA, Technical Practice Aids, PA sec. 16,240)</th>
<th>This practice aid is a response to practitioners’ current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics.</th>
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<tr>
<td>Revised: June 2007 (Nonauthoritative)</td>
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<tr>
<th>AICPA PITF PA 07-1, Dating of the Auditor’s Report and Related Practical Guidance (AICPA, Technical Practice Aids, PA sec. 16,290)</th>
<th>This practice aid provides guidance regarding application of certain provisions of AU section 339, primarily related to dating the auditor’s report.</th>
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<tr>
<td>Issue Date: January 2007 (Nonauthoritative)</td>
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Audit Developments

Recently Issued Guidance

.73 The AICPA ASB recently issued SAS No. 115, which supersedes SAS No. 112. Among the changes made by the new SAS are revisions to the definitions of the terms material weakness and significant deficiency that had been previously established in SAS No. 112. SAS No. 115 contains the following revised definitions of the terms material weakness and significant deficiency as they relate to internal control over financial reporting:

- **Material weakness.** A deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis. (Note that in SAS No. 115, a reasonable possibility exists when the likelihood of the event is either reasonably possible or probable as those terms are used in Financial Accounting Standards Board Statement No. 5, Accounting for Contingencies.)

- **Significant deficiency.** A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

.74 Even though the new definitions might appear to allow more flexibility in determining what to report as a significant deficiency, auditors should keep in mind that the new SAS states that the severity of a deficiency depends on (1) the magnitude of the potential misstatement resulting from the deficiency or deficiencies; and (2) whether there is a reasonable possibility that the entity’s controls will fail to prevent, or detect and correct, a misstatement of an account balance or disclosure. These criteria are very similar to the “magnitude” and “likelihood” criteria that were previously “built into” the significant deficiency definition.
SAS No. 115 also revises the list of deficiencies in internal control that are indicators of material weaknesses. The list now consists of:

- identification of fraud, whether or not material, on the part of senior management;
- restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud;
- identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected by the entity’s internal control; and
- ineffective oversight of the entity’s financial reporting and internal control by those charged with governance.

Finally, SAS No. 115 no longer includes a list of deficiencies that ordinarily would be considered at least significant deficiencies and contains a revised illustrative written communication to management and those charged with governance of material weaknesses and significant deficiencies.

**SAS No. 115 and Implications for GAS Audits**

As occurred when SAS No. 112 was issued, a ripple effect to other governmental standard-setters and regulators will occur as a result of the issuance of SAS No. 115. As of the writing of this alert, the GAO has already issued interim guidance on complying with GAS in conjunction with SAS No. 115 and SSAE No. 15, which can be accessed at www.gao.gov/govaud/ybk01.htm. The issuance of the GAO interim guidance was necessary because the internal control definitions used in the new AICPA standards differ from the definitions used in the July 2007 revision of GAS (which had been based on SAS No. 112 definitions).

GAO states that the purpose of its guidance is to facilitate reporting of internal control deficiencies identified in engagements performed under GAS and the new AICPA standards and to assist auditors in complying with GAS until the next update of the Yellow Book. The following interim guidance is provided for complying with the internal control reporting requirements of GAS:

- Auditors may satisfy the internal control reporting requirements in GAS paragraph 5.11 by including in the Yellow Book report on internal control all identified material weaknesses and significant deficiencies following the new definitions and requirements from SAS No. 115 and SSAE No. 15, as applicable, providing those definitions, and describing the scope of testing performed on the entity’s internal control over financial reporting.
- Auditors are reminded to comply with all other relevant GAS requirements related to reporting deficiencies in internal control, such as developing findings and providing recommendations for corrective action if findings are sufficiently developed (GAS paragraphs 5.21 and 6.42), obtaining views of responsible officials (GAS paragraphs 5.32–.38 and 6.44–.50), and ensuring appropriate report distribution (GAS paragraphs 5.44 and 6.56).

The GAO guidance becomes effective concurrent with the auditors’ implementation of SAS No. 115 or SSAE No. 15 or both. The GAO guidance does state that the Comptroller General’s Advisory Council on Government Auditing Standards will fully deliberate this issue in conjunction with the next GAS update, at which time the interim guidance may change.

**SAS No. 115 and Implications for Circular A-133 and Other Governmental Audits**

With GAO’s issuance of the previously described interim guidance, it is now permissible for auditors to implement SAS No. 115 on their financial statement audits performed under GAS and on internal control examinations performed under SSAE No. 15. However, auditors should keep in mind that Circular A-133 and other similar federal regulations or audit guides (for example, the U.S. Department of Housing and Urban Development Consolidated Audit Guide) have not yet been updated to reflect new internal control definitions for reporting on internal control over compliance. Therefore, it would not be appropriate for
auditors to use definitions for reporting on internal control over compliance that may be consistent with the definitions found in SAS No. 115 until such time as Circular A-133 or other regulations or guides are amended to allow usage of new updated definitions.

The GAQC staff is in the process of beginning to work with OMB and other federal agencies that require reporting on internal control over compliance to determine the changes needed to their regulations or federal audit guides or both as a result of the new AICPA standards. Visit the GAQC Web site (www.aicpa.org/GAQC) for reports on progress made in this area by OMB and other federal agencies.

**AICPA Updates Audit Guide Government Auditing Standards and Circular A-133 Audits**

The 2008 edition of the AICPA Audit Guide Government Auditing Standards and Circular A-133 Audits is available to provide auditors with more in-depth information on audits subject to GAS and Circular A-133. If you perform audits under either GAS or Circular A-133, this guide is a key resource that should be in your library. It incorporates audit guidance issued up through August 1, 2008 and includes the following:

- Guidance on planning and performing audits under the July 2007 revision of Government Auditing Standards
- Conforming changes for AU section 120, Defining Professional Requirements in Statements on auditing Standards (AICPA, Professional Standards, vol. 1)
- Guidance on the auditor’s responsibilities as found in SAS Nos. 112 and 114, including identifying, evaluating, and reporting deficiencies in internal control related to both financial reporting and compliance, and the auditor’s communication with those charged with governance
- Updated terminology and references to AU sections to be consistent with the AICPA risk assessment standards
- Enhancements to provide additional clarity on certain problem areas noted in the PCIE report, primarily in chapters 7 and 9 relating to the SEFA and internal control over compliance

The guide can be ordered by calling the AICPA at (888)777-7077 or going online at www.cpa2biz.com.

**AICPA Peer Review Checklists—A Tool to Help Improve Audit Quality**

In performing peer reviews, review teams must complete all relevant programs and checklists issued by the AICPA Peer Review Board. (Note that the standards for performing and reporting on peer reviews commencing on or after January 1, 2009, have been revised.) The AICPA updates its Peer Review Checklists annually; the 2008 versions of those checklists (which include checklists on state and local government, health care, and not-for-profit audits; GAS audits; single audits; and HUD audits) are now available. Although intended for use in peer reviews, the various relevant checklists are a helpful tool for firms or audit organizations to use to ensure auditors have not overlooked anything significant before issuing their audit reports. Taking this step may help you improve your audit quality. The various relevant checklists can be accessed through the GAQC at http://gaqc.aicpa.org/Resources/Research+Tools+and+Aids/2008+Peer+Review+Checklists.htm.

**Common Deficiencies Found During Peer Reviews of Audits of Entities Subject to GAS**

Among the deficiencies commonly found during peer reviews of audits of entities subject to GAS and Circular A-133 are the following:

- Failure to document tests of controls and compliance for engagements subject to Circular A-133, perform adequate tests in other key areas, and to test controls over compliance in Single Audit Act engagements
• Failure to adequately design compliance and control tests, including sampling applications, to support the reports issued
• Failure to include proper Circular A-133 reports
• Failure to include proper reports on internal control or compliance
• Failure to disclose reportable conditions (now significant deficiencies) or material noncompliance with GAS
• Failure to refer to reports on controls and compliance in the report on financial statements
• Failure to include required disclosures
• Failure to perform an audit that was required by statute and performing a review instead
• Failure to meet GAS CPE requirements

.85 This list does not contain all the areas of recurring deficiencies. More information is available on the AICPA Web site at www.aicpa.org/download/members/Div/practmon/Revised_Deficiency_Guidance_for_2008-_FINAL.pdf.

Recent AICPA Independence and Ethics Pronouncements

.86 Audit Risk Alert Independence and Ethics Developments—2008 (product no. 022479kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

.87 The AICPA has compiled a list of violations found as a result of recent ethics investigations. This list contains a number of violations that occur frequently in government and not-for-profit organization engagements. The following is a brief excerpt of that listing:

• Failure to accurately identify and test all major programs in accordance with Circular A-133
• Failure to obtain sufficient competent audit evidence to support the auditor’s report (found in various areas of audits but most frequently found in the work performed auditing major programs)
• Failure to note that the SEFA did not provide total federal awards expended for each individual federal program by Catalog of Federal Domestic Assistance (CFDA) number
• Failure to report audit findings in the Schedule of Findings and Questioned Costs with the required elements of criteria, condition, cause, and effect

Independence Requirements Under AICPA, GAS, and Circular A-133

.88 Auditors who perform audits under GAS (including Circular A-133 audits), should be aware of the independence rules in those standards and regulations, as well as the independence rules of the AICPA. The AICPA’s Professional Ethics Executive Committee proposes and issues ethics interpretations and rulings relating to independence and other ethics matters. You can download recent proposals and rulings from the AICPA Web site at www.aicpa.org/members/div/ethics/index.htm.

Help Desk—In July 2006, the AICPA published a Practice Aid, Independence Compliance: Checklists and Tools for Complying With AICPA and GAO Independence Requirements (product no. 006627kk). This valuable tool contains a series of checklists to help auditors determine their compliance with applicable independence rules. The publication is currently being updated and a new edition will be available in 2009. This practice aid and others can be obtained at www.cpa2biz.com or by calling the AICPA at (888) 777-7077.
For audits conducted in accordance with GAS, auditors and audit organizations also are subject to the GAS independence rules. Those rules, which are, in some cases, very similar to the AICPA independence rules and in other cases more restrictive, specify when personal, external, and organizational impairments to independence exist. The GAO has available on its Web site a question and answer document, Answers to Independence Standard Questions, to address its independence standard.


Finally, auditors should note that section 305(b) of Circular A-133 contains an additional independence requirement. Under Circular A-133, an auditor who prepares the indirect cost proposal or cost allocation plan may not also perform the single audit when indirect costs recovered by the auditee during the prior year, as defined, exceeded $1 million.

On the Horizon

Auditors should keep abreast of auditing, compliance, and accounting developments and upcoming guidance that may affect their engagements. Clearly, with all of the activity described in this alert, particularly the activities in response to the PCIE report, auditors will likely have many developments to keep track of in the next year. Auditors may want to bookmark the GAQC Web site at www.aicpa.org/GAQC and check it regularly for the latest news and developments.

The following table lists the various standard setting bodies’ Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain in-depth information about proposed standards and other projects in the pipeline. Readers should refer to information provided by the various standard setting bodies for further information.

<table>
<thead>
<tr>
<th>Standard-Setting Body</th>
<th>Web Site</th>
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<tbody>
<tr>
<td>AICPA Auditing Standards Board (ASB)</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/">www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/</a></td>
</tr>
<tr>
<td>Financial Accounting Standards Board (FASB)</td>
<td><a href="http://www.fasb.org">www.fasb.org</a></td>
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<tr>
<td>Governmental Accounting Standards Board (GASB)</td>
<td><a href="http://www.gasb.org">www.gasb.org</a></td>
</tr>
<tr>
<td>Office of Management and Budget (OMB)</td>
<td><a href="http://www.omb.gov/grants">www.omb.gov/grants</a></td>
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<tr>
<td>Professional Ethics Executive Committee (PEEC)</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/">www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/</a></td>
</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
<td><a href="http://www.pcaob.org">www.pcaob.org</a></td>
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Auditing Pipeline

Proposed Revisions to SAS No. 74

The ASB is continuing its work on revising SAS No. 74. This project was primarily a response to the issuance of the PCIE report and its findings and recommendations. An exposure draft of a revised standard
is expected to be issued in the fourth quarter of 2008, with the revised final statement to be issued during 2009. Auditors should visit the GAQC Web site at www.aicpa.org/GAQC for further developments.

Resource Central

.94 The following are various resources that auditors engaged in GAS and Circular A-133 audits may find beneficial.

AICPA GAQC

.95 The GAQC is a firm-based, voluntary membership center designed to help CPAs meet the challenges of performing quality audits in this unique and complex area. The GAQC’s primary purpose is to promote the importance of quality governmental audits and the value of such audits to purchasers of governmental audit services.

.96 The mission of the GAQC is to do the following:

- Raise awareness about the importance of governmental audits
- Serve as a comprehensive resource provider on governmental audits for member firms
- Create a community of firms that demonstrates a commitment to governmental audit quality
- Provide center members with an online forum tool for sharing best practices and discussing audit, accounting, and regulatory issues
- List member firms to enable purchasers of governmental audit services to identify firms that are members
- Provide information about the center’s activities to other governmental audit stakeholders

.97 The GAQC has been in existence since 2004. Since its launch, center membership has grown to over 1,100 firms from 50 states. The center’s focus is to promote the highest quality audits and to save firms time by providing a centralized place to find information they need, when they need it, to maximize quality and practice success. Center resources include the following:

- E-mail news alerts on current audit and regulatory developments that keep member firms informed about the latest developments
- Dedicated center Web site at www.aicpa.org/GAQC with links called Resources, Community, and Events and Products, as well as a complete listing of GAQC members in each state
- Online member discussion forums for sharing best practices and discussing issues firms are facing
- Webcasts and teleconferences, with optional CPE, updating members on a variety of technical, legislative, regulatory, and practice management subjects (note that these activities are archived on the GAQC Web site for GAQC member firms)

Help Desk—With all of the quality issues being noted in governmental audits, as discussed in this alert, your firm should consider joining the center. To enroll or learn more about the GAQC, including details on the membership requirements and fees for membership, go to www.aicpa.org/GAQC or e-mail the GAQC staff at GAQC@aicpa.org. To preview member benefits, go to http://gaqc.aicpa.org/Memberships/.
AICPA State and Local Government Expert Panel

The State and Local Government Expert Panel is an AICPA volunteer group whose purpose is to identify state and local government financial reporting and auditing issues and to work with appropriate bodies for resolutions benefiting the public interest; to conduct liaison activities with the GASB, regulators such as the GAO and OMB, and applicable industry associations; and to advise and assist in the development of AICPA products and services related to state and local government audits. For information about the activities of the State and Local Government Expert Panel, visit the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_government.htm.

AICPA Not-For-Profit Organization Expert Panel

The Not-For-Profit Organization Expert Panel is an AICPA volunteer group whose purpose is to identify financial reporting and auditing issues unique to not-for-profit organizations, to work with appropriate bodies for resolutions benefiting the public interest, to conduct liaison activities with the AICPA Accounting Standards Executive Committee (AcSEC) and Financial Accounting Standards Board (FASB), and to advise and assist in the development of AICPA products and services related to not-for-profit organizations. For information about the activities of the Not-For-Profit Organization Expert Panel, visit the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_notforprofit.htm.

Publications

You may find the following publications useful with respect to GAS and Circular A-133 audits. Choose the format best for you—online, print, or CD-ROM.

- Audit Guide Government Auditing Standards and Circular A-133 Audits (2008) (product no. 012748kk [paperback], WRF-XXkk [online with the associated Audit Risk Alert], or DRF-XXkk [CD-ROM with the associated Audit Risk Alert])
- Audit and Accounting Guide Health Care Organizations (2008) (product no. 012618kk [paperback], WHC-XX [online with the associated Audit Risk Alert], or DHC-XX [CD-ROM with the associated Audit Risk Alert])
- Audit and Accounting Guide Not-For-Profit Organizations (2008) (product no. 012648kk [paperback], WNP-XXkk [online with the associated Audit Risk Alert], or DNP-XXkk [CD-ROM with the associated Audit Risk Alert])
- Audit and Accounting Guide State and Local Governments (2008) (product no. 012668kk [paperback], WGG-XXkk [online with the associated Audit Risk Alert], or DGG-XXkk [CD-ROM with the associated Audit Risk Alert])
- Audit Guide Analytical Procedures (2008) (product no. 012558kk [paperback], WAN-XXkk [online], or DAN-XXkk [CD-ROM])
- Audit Guide Assessing and Responding to Audit Risk in a Financial Statement Audit (2006) (product no. 012456kk [paperback] or WRA-XXkk [online])
- Audit Guide Audit Sampling (2008) (product no. 012538kk [paperback], WAS-XXkk [online], or DAS-XXkk [CD-ROM])
- Comprehensive Audit Risk Alert—2008 (product no. 022338kk [paperback], WGE-XXkk [online], or DGE-XXkk [CD-ROM])
- Audit Risk Alert Independence and Ethics Developments—2008 (product no. 022479kk [paperback], WIA-XXkk [online], or DIA-XXkk [CD-ROM])
Audit Risk Alert Health Care Industry Developments—2008 (product no. 022349kk [paperback], WHC-XXkk [online with the associated Audit and Accounting Guide], or DHC-XXkk [CD-ROM with the associated Audit and Accounting Guide])

Audit Risk Alert Not-For-Profit Organizations Industry Developments—2008 (product no. 022428kk [paperback], WNP-XXkk [online with the associated Audit and Accounting Guide], or DNP-XXkk [CD-ROM with the associated Audit and Accounting Guide])

Audit Risk Alert State and Local Governmental Developments—2008 (product no. 022438kk [paperback], WGG-XXkk [online with the associated Audit and Accounting Guide], or DGG-XXkk [CD-ROM with the associated Audit and Accounting Guide])

Audit Risk Alert Understanding the New Auditing Standards Related to Risk Assessment (product no. 022526kk)

Checklist and Illustrative Financial Statements for State and Local Governments (product no. 009038kk [paperback] or WSG-CLkk [online])

Checklist and Illustrative Financial Statements for Not-For-Profit Organizations (product no. 008988kk [paperback] or WNP-CLkk [online])

Independence Compliance: Checklists and Tools for Complying with AICPA and GAO Independence Requirements (product no. 006627kk [paperback])

Audit and Accounting Manual (2008) (product no. 005138kk [paperback], WAM-XXkk [online], or AAM-XXkk [loose leaf])

Accounting Trends and Techniques—Not-For-Profit Organizations (product no. 006616kk [paperback])

AICPA reSOURCE: Accounting and Auditing Literature

.101 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm’s needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to the AICPA’s latest Professional Standards, Technical Practice Aids, Audit and Accounting Guides (more than 20), Audit Risk Alerts (more than 15), and Accounting Trends & Techniques. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

CPE

.102 The AICPA offers a number of CPE courses that are valuable to CPAs working in public practice and industry. Among the many courses, the following may be of specific interest to auditors of organizations subject to GAS and Circular A-133 audits.

- 2007 Revised Yellow Book: Government Auditing Standards (product no. 736117kk [text] or 187107kk [DVD/manual])
- Studies on Single Audit and Yellow Book Deficiencies (product no. 733032kk [text])
- Solving Complex Single Audit Issues for Government and Nonprofit Organizations (product no. 734412kk [text])
- Applying A-133 to Nonprofit and Governmental Organizations (product no. 730299kk [text] or 187209kk [DVD/manual])
- Audits of HUD-Assisted Projects (product no. 730299kk [text])

Visit www.cpa2biz.com for a complete list of CPE courses.
Online CPE

.103 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through cpa2biz.com, is the AICPA’s flagship online learning product. AICPA members pay $180 for a new subscription and $149 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics, including governmental and nonprofit accounting and auditing. Some courses of specific relevance to GAS and Circular A-133 audits include:

- Revised Yellow Book: Government Auditing Standards
- Single Audits: Applying A-133 to Nonprofit and Government
- Single Audits: Solving Complex Single Audit Issues for Government and Nonprofit Organizations
- Single Audits: Studies on Single Audit and Nonprofit Organizations
- HUD Auditing: Advanced

To register or learn more, visit www.cpa2biz.com.

Webcasts

.104 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two hour CPE programs that bring you the latest topics from the profession’s leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM. To register or learn more, visit www.cpa2biz.com.

Member Service Center

.105 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.106 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA’s Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. Beginning January 2008, hotline hours were extended so that the hotline is now available from 9 a.m. to 8 p.m. on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/.

Ethics Hotline

.107 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA’s Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077.

Industry Conference

.108 The AICPA sponsors four annual conferences that include a focus on GAS and Circular A-133 topics in the summer and fall of each year.
Governmental Accounting and Auditing Update Conference (GAAC) EAST is scheduled to be held August 10–11, 2009, in Washington, D.C., and its counterpart, GAAC WEST, will be held September 21–22, 2009, in Denver, Colorado. These conferences are designed for CPAs working in federal, state, and local government; public practitioners with government clients; and regulators who need to be aware of emerging developments should attend this conference to remain current on the issues. Attending one of these conferences is a great way to receive timely guidance along with practical advice on how to handle new legislation and standards from key government officials and representatives of the accounting profession— including the standard setters themselves.

AICPA National Governmental and Not-for-Profit Training is scheduled to be held October 26–28, 2009, in Atlanta, Georgia. If you need hands-on training and are a CPA in public practice—or a governmental or not-for-profit staffer—then this conference is for you. You’ll hear directly from the standards setters and industry leaders on a variety of topics including developments in governmental accounting and auditing, the latest in proposed regulations and laws on the local, state, and federal government levels, as well as those affecting the not-for-profit sector and more.

Not-for-Profit Industry Conference is scheduled to be held June 11–12, 2009, in Washington, D.C. The conference offers a wide range of topics geared to not-for-profit professionals at every level: tax, management, audit and accounting issues, fundraising, and regulatory issues.

For further information about the conferences, call (888) 777-7077 or visit www.cpa2biz.com.

Industry Web Sites

The Internet covers a vast amount of information that may be valuable to auditors of organizations that are subject to GAS or Circular A-133 audits, including current issues and developments. Some of the more relevant sites are shown in the appendix of this alert. The governmental or not-for-profit audit practice sections of some of the larger CPA firms may also contain specific auditing and accounting information that is helpful to auditors.

This Audit Risk Alert replaces Government Auditing Standards and Circular A-133 Audits—2007/08.

The Audit Risk Alert Government Auditing Standards and Circular A-133 Developments is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year’s Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to sreed@aicpa.org or write to:

Susan M. Reed, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110
Appendix A—Common Deficiencies Identified in the PCIE Report

**materiality.** In single audits, the auditor must consider his or her findings in relation to each major program, which is a significantly lower materiality level than all programs combined. In some of the audits reviewed, the auditor did not document whether he or she considered materiality at the individual major program level.

**internal control.** The report found that in many single audits, auditors are not documenting their understanding of internal control over compliance as required by section .500(c)(1) of Circular A-133 in a manner that addresses the five elements of internal control. Further, the report stated that auditors did not document testing internal control of at least some compliance requirements as required by section .500(c)(2) of Circular A-133.

**compliance.** The report stated that in some audits, auditors are not documenting compliance testing of at least some compliance requirements. For most audits considered unacceptable, the lack of documentary evidence for compliance testing was substantial. They found that the audit documentation did not always include evidence that the auditor tested major program compliance requirements or explain why certain generally applicable requirements identified in the OMB Compliance Supplement were not applicable to the audit.

Also, in some cases the auditor documented that types of compliance requirements identified as generally applicable to the major program in part 2 of the OMB Compliance Supplement were not applicable (by only marking “N/A” next to the item in an audit program) but did not explain why.

**material reporting errors.** Auditors misreported coverage of major programs. This occurred when the Summary of Auditor Results section of the Schedule of Findings and Questioned Costs identified that one or more major programs were audited as a major program when the audit documentation did not include support for all of the programs listed. Though inadvertent, this is a very consequential error because report users may erroneously rely on opinions that major programs have been audited as major.

**sampling.** The PCIE report notes inconsistent numbers of transactions selected for testing of internal control and compliance testing for the Allowable Costs/Cost Principles compliance requirement across the audits that they reviewed. Also, many single audits did not document the number of transactions and the associated dollars of the universe from which the transactions were drawn.

**risk assessments of federal programs.** The report cited the following kinds of deficiencies in risk assessments of federal programs:

- Required risk analyses were not documented at all.
- The basis for the assessments of risk was not documented.
- The documentation indicated that the risk assessment was not performed or not properly performed for reasons including not considering all programs, improperly clustering programs, not clustering programs, or mistakenly categorizing a program as Type A or as Type B.
- The risk assessment decision was not consistent with information in the audit documentation.

**apparent audit findings not reported.** In this scenario, the audit documentation or management letter content included matters that appeared to be audit findings. However, they were not reported as audit findings, and there was no audit documentation explaining why.

**audit finding elements.** A significant percentage of the audits reviewed in both strata did not include all of the required reporting elements in the audit findings.

**Schedule of Expenditures of Federal Awards (SEFA) problems.** For many audits reviewed, one or more of the following required SEFA content items were omitted. The report acknowledges that SEFA preparation is a client responsibility but that the auditor reports on the SEFA in relation to the financial statements and that the information in the SEFA is key to major program determination. Issues were found with the following items:
• Subgrant awards numbers assigned by pass-through entities not included
• Names of pass-through entities missing
• Grantor federal agency names missing
• Grantor federal agency subdivision names missing
• Multiple lines for CFDA numbers shown—total expenditures for CFDA not shown
• Programs that are parts of a cluster not shown as such
• Notes to SEFA missing
• Correct CFDA number omitted
• Research and development programs not identified as such

management representations. For several audits, some or all of the management representations (identified in the AICPA’s Audit Guide Government Auditing Standards and Circular A-133 Audits) were not obtained. In a few other cases, the management representations were obtained several days prior to the dates of the auditor’s reports.

other findings. Numerous other findings were noted by reviewers, primarily caused by a lack of due professional care. They include the following:
• Low-risk auditee determination not documented or incorrect
• Minimum Percentage of Coverage requirement not met
• Audit programs missing or inadequate for part of the single audit
• Part of a major program or a major program cluster not tested
• The Summary of Auditor’s Results section of the Schedule of Findings and Questioned Costs missing some information, or some information was erroneous
• Threshold distinguishing Type A and Type B programs erroneous
• Indications that current compliance requirements not considered
Appendix B—Additional Web Resources

Here are some Web sites you may find useful.

<table>
<thead>
<tr>
<th>Web Site Name</th>
<th>Content</th>
<th>Web Site</th>
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<tbody>
<tr>
<td>American Institute of CPAs (AICPA)</td>
<td>Summaries of recent auditing and other professional standards as well as other AICPA activities</td>
<td><a href="http://www.aicpa.org">www.aicpa.org</a></td>
</tr>
<tr>
<td></td>
<td></td>
<td><a href="http://www.cpa2biz.com">www.cpa2biz.com</a></td>
</tr>
<tr>
<td>Catalog of Federal Domestic Assistance</td>
<td>Electronic searchable version of the CFDA, which may be useful for identifying or verifying CFDA numbers</td>
<td><a href="http://www.cfda.gov">www.cfda.gov</a></td>
</tr>
<tr>
<td>Department of Education: Office of Inspector General Nonfederal Audits Team</td>
<td>Provides sources, including various audit guides, to assist in the conduct and understanding of single audits and audits of Student Financial Aid</td>
<td><a href="http://www.ed.gov/about/offices/list/oig/nonfed/index.html">www.ed.gov/about/offices/list/oig/nonfed/index.html</a></td>
</tr>
<tr>
<td>Department of Housing and Urban Development: Office of Inspector General</td>
<td>Among the items found on this Web site is the Consolidated Audit Guide for Audits of HUD Programs</td>
<td><a href="http://www.hud.gov/offices/oig">www.hud.gov/offices/oig</a></td>
</tr>
<tr>
<td>Federal Audit Clearing House</td>
<td>This Web site contains the various versions of the data collection form (Form SF-SAC), provides a means for electronic completion and submission of the data collection form</td>
<td><a href="http://harvester.census.gov/fac">http://harvester.census.gov/fac</a></td>
</tr>
<tr>
<td>The Federal Reserve Board</td>
<td>Key interest rates</td>
<td><a href="http://www.federalreserve.gov">www.federalreserve.gov</a></td>
</tr>
<tr>
<td>Financial Accounting Standards Board (FASB)</td>
<td>Summaries of recent accounting pronouncements and other FASB activities</td>
<td><a href="http://www.fasb.org">www.fasb.org</a></td>
</tr>
<tr>
<td>USA.gov</td>
<td>Portal through which all government agencies can be accessed</td>
<td><a href="http://www.usa.gov">www.usa.gov</a></td>
</tr>
<tr>
<td>Governmental Accounting Standards Board (GASB)</td>
<td>Summaries of recent accounting pronouncements and other GASB activities</td>
<td><a href="http://www.gasb.org">www.gasb.org</a></td>
</tr>
<tr>
<td>Government Printing Office Access</td>
<td>Includes a comprehensive list of official federal resources available (and related links) and is the official online bookstore for government publications</td>
<td><a href="http://www.gpoaccess.gov">www.gpoaccess.gov</a></td>
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<table>
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<tr>
<th>Web Site Name</th>
<th>Content</th>
<th>Web Site</th>
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</thead>
<tbody>
<tr>
<td>IGnet</td>
<td>Includes electronic versions of the audit review guidelines that the Federal Inspectors General used in performing reviews of selected single audits</td>
<td><a href="http://www.ignet.gov/">www.ignet.gov/</a></td>
</tr>
<tr>
<td>Office of Management and Budget (OMB)</td>
<td>Includes information on the federal budget, the President’s management agenda, and regulatory and legislative information and OMB Circulars</td>
<td><a href="http://www.whitehouse.gov/omb">www.whitehouse.gov/omb</a></td>
</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
<td>Information on accounting and auditing activities of the PCAOB and other matters</td>
<td><a href="http://www.pcaobus.org/">www.pcaobus.org/</a></td>
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[The next page is 8987.]
AAM Section 8240

Independence and Ethics Developments—2008

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert is designed to provide illustrative information with respect to the subject matter covered. It does not establish standards or preferred practices. The material has not been considered or acted upon by senior technical committees or the AICPA Board of Directors and does not represent an official opinion or position of the AICPA. It is provided with the understanding that the author and publisher are not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional person should be sought. The author and publisher make no representations, warranties, or guarantees as to and assume no responsibility for the content or application of the material contained herein and expressly disclaim all liability for any damages arising out of the use of, reference to, or reliance on such material.

Written by Catherine Allen, CPA
Edited by Dennis W. Ridge, Jr., CPA

Accounting and Auditing Publications

Acknowledgments

The AICPA staff is grateful to Lisa Snyder, CPA, and Ellen Goria, both of the AICPA Professional Ethics Division, for their significant and valuable contributions to the development of this Audit Risk Alert.

Our special thanks to Catherine Allen who developed and wrote this Audit Risk Alert.

How This Alert Helps You

.01 This Audit Risk Alert (alert) informs you of recent developments in the important areas of independence and ethics for accountants. This alert helps you understand your independence requirements under the AICPA Code of Professional Conduct (Code) and, if applicable, certain other rule-making and standard-setting bodies. We present a section titled “Digest of the AICPA Independence Rules” in plain English at the end of this alert so you can understand and apply the independence rules with greater confidence.

AICPA Independence and Ethics Developments

New and Revised AICPA Independence Rules

Indemnification and Limitation of Liability Provisions in Connection With Audit and Other Attest Services

.02 In September 2006, the Professional Ethics Executive Committee (PEEC) issued Omnibus Exposure Draft—Proposed Interpretations on Indemnification, Limitation of Liability and ADR Clauses in Engagement Letters (proposed Interpretation No. 101-16), Forensic Accounting Services and Tax Compliance Services. Since that time and in light of varied commentary received on that proposal and initiatives underway to address the issues, the PEEC decided to address the indemnification issue outside of the independence rules and to monitor these developments.

This interpretation states that a member who engages in the following activities has committed an act discreditable to the profession under the Code:

- Enters into a contract to perform audit or other attest services that are subject to the requirements of certain regulators when that contract includes an indemnification or limitation of liability provision that would cause the regulated entity or the member to violate such requirements or cause a member to be disqualified from providing the services to the regulated entity
- Directs or knowingly permits another individual to enter into a contract to perform audit or other attest services that are subject to the requirements of certain regulators when that contract includes an indemnification or limitation of liability provision that would cause the regulated entity or the member to violate such requirements or cause a member to be disqualified from providing the services to the regulated entity


Ethics Interpretation No. 501-8, which became effective on July 31, 2008, is available on the AICPA Web site at [www.aicpa.org/about/code/et_500.html#et_501.09](http://www.aicpa.org/about/code/et_500.html#et_501.09).

**New Independence Guidance**

*Independence Impact of Providing FASB Statement No. 141 (revised 2007) Services to an Attest Client*

In August 2008, the staff of the Professional Ethics Division issued nonauthoritative guidance (in the form of a frequently asked question [FAQ]) on the question of whether, under Ethics Interpretation No. 101-3, “Performance of Nonattest Services,” under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .05), members could assist an attest client in applying Financial Accounting Standards Board (FASB) Statement No. 141 (revised 2007), *Business Combinations*, or FASB Statement No. 142, *Goodwill and Other Intangible Assets*, while maintaining independence. Specifically, the FAQ addresses whether the following services would be considered to impair independence:

- Providing the client advice on valuation methodologies and assumptions needed to perform the valuation
- Providing advice on valuation templates, software, or other tools that allow the client to determine an appropriate value for acquired assets, goodwill, contingent consideration, and so on

Under the FAQ, performing the valuation for the client (for example, the member provides the client a firm-developed template or software product or inserts amounts into a template or software product and (1) the results of the service would be material to the financial statements and (2) the appraisal or valuation involves a significant degree of subjectivity) impairs independence.
If the requirements of Ethics Interpretation No. 101-3 have been met, the following services would be permitted:

- Advising the client on various valuation methodologies that are available and the assumptions to be made in performing the valuation. The member also may help the client understand the accounting standards and the nature of the necessary accounting adjustments.

- Providing the client generic or standardized templates or software products that have not been developed by the firm to assist the client in performing the valuation. The formulas in generic or standardized products are well established and subject to only minor judgments or interpretations, resulting in valuations that would be expected to be similar to those produced by other vendor’s products.

The FAQ, incorporated as Question 1, “Appraisal, Valuation, and Actuarial Services,” of the FAQ document, is available on the AICPA Professional Ethics Division’s Web site at www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/Resources+and+Tools/Frequently+Asked+Questions.htm#appraisalvaluation.

Recognition of International Accounting Standards Board as an Accounting Standard Setter


Compliance Reminder Regarding Other Authoritative Bodies

The independence and ethics rules under the Code apply to all members of the AICPA. However, other rule-making and standard-setting bodies, such as the SEC, the Public Company Accounting Oversight Board (PCAOB), the Government Accountability Office (GAO), the U.S. Department of Labor (DOL), state boards of accountancy, and state CPA societies, also have independence and ethics rules with which members must comply, if applicable, in addition to the AICPA rules. The rules of the SEC, PCAOB, and GAO are discussed briefly in this alert. You should refer to the original text of each organization’s rules for full guidance.

SEC Independence Rules

Rule 2-01, Qualifications of Accountants, of Regulation S-X sets forth the SEC’s independence rules. The rule is designed to ensure that auditors are qualified and independent of their audit clients both in fact and appearance. Accordingly, the rule establishes restrictions on financial, employment, and business relationships between an accountant and an audit client and the provisions of certain nonaudit services to an audit client.

Rule 2-01(b) begins with a general standard of auditor independence, which states the following:

The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant’s engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.
.16 The succeeding paragraphs reflect the application of the general standard to particular circumstances. In addition, the second preliminary note to Rule 2-01 states the following:

The rule does not purport to, and the Commission could not, consider all circumstances that raise independence concerns, and these are subject to the general standard in Rule 2-01(b). In considering this standard, the Commission looks in the first instance to whether a relationship or the provision of a service: creates a mutual or conflicting interest between the accountant and the audit client; places the accountant in the position of auditing his or her own work; results in the accountant acting as management or an employee of the audit client; or places the accountant in a position of being an advocate for the audit client.

.17 The rule indicates that the preceding factors are general guidance only and their application may depend on particular facts and circumstances. Thus, Rule 2-01 also provides that

... in determining whether an accountant is independent, the Commission will consider all relevant facts and circumstances. For the same reason, registrants and accountants are encouraged to consult with the Commission’s Office of the Chief Accountant before entering into relationships, including relationships involving the provision of services, that are not explicitly described in the rule.

Recent SEC Independence Information

.18 An employee of the SEC Office of the Chief Accountant who is responsible for auditor independence (SEC staff) presented at the 2007 AICPA National Conference on Current SEC and PCAOB Developments. The SEC staff discussed the following topics: the primary sources of SEC independence information, nine FAQs on independence issued by the SEC staff in 2007, and a few inquiries the SEC staff regularly receives. The areas the SEC staff discussed are summarized as follows:

- Initial Public Offering (IPO). The SEC staff reminded the audience that if their client files an IPO with the SEC, the auditor is required to be independent under the SEC’s rules for all periods included in the filing (“the audit period”). For example, prior to the IPO, the firm may have provided services or had business or fee relationships with the company that violated SEC independence rules. Even though the firm was not subject to SEC rules at the time services were provided or the relationship existed, the firm will be held to the SEC rules for those prior periods. This includes not only nonaudit services, business, and fee relationships that a firm may have had with the client in recent years, but also extends to associated entities of the firm and affiliates of the audit client.

- Accounting Assistance. The SEC staff said it receives many questions about the type of accounting assistance auditors may provide to their clients. The two main threats noted were the threat of self audit and acting as management. The SEC staff suggested sources of suggested guidance, including the following, among others:
  — May 2005 Staff Statement on Management’s Report on Internal Control Over Financial Reporting


- Associated Entities. Another FAQ the staff receives is whether an accounting firm is an associated entity of the auditor. Some factors the staff considers in answering such questions include the following:
  — Does the auditor refer to the other firm in its audit report or take responsibility for the other firm’s work?
  — Do the auditor and the other firm have common ownership, profit-, or cost-sharing arrangements?
— Do the auditor and the other firm share management, a common brand name, resources, or quality controls?

Footnotes 489 and 491 of the November 2000 SEC adopting release Revision of the Commission’s Auditor Independence Requirements provide related guidance. These footnotes refer to several no-action letters issued to firms on this issue, citations to the SEC Codification, and the AICPA rules.

- Consents and Restatements. The SEC staff also discussed the independence requirements for an auditor who is asked to provide a consent relating to his or her previously issued audit opinion or issue an opinion on restated financial statements. First, issuing a consent does not require the auditor to be independent, assuming the professional engagement period has ended (the final report issued). However, if the auditor will issue a restatement and dual-dates the audit opinion, the auditor must be independent for the entire audit and professional engagement period.

PCAOB Rules Regarding Independence and Ethics

.19 The PCAOB has the authority to establish ethics and independence standards in accordance with Section 103(a), “Auditing, Quality Control, and Ethics Standards,” and Section 103(b), “Independence Standards and Rules,” of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). Firms that issue audit reports on public companies are required to register with the PCAOB. Failure to do so may result in disciplinary action. Additionally, any registered public accounting firm or person associated with such a firm that fails to adhere to applicable PCAOB standards may be the subject of a PCAOB disciplinary proceeding in accordance with Section 105, Investigations and Disciplinary Proceedings, of Sarbanes-Oxley. Under Section 107, Commission Oversight of the Board, of Sarbanes-Oxley, PCAOB rules become effective only after they are approved by the SEC. The PCAOB independence and ethics rules include the following:

- PCAOB Rule 3100, Compliance with Auditing and Related Professional Practice Standards (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”)

.20 The full text of these rules can be found at www.pcaob.org/Rules/Rules_of_the_Board/Section_3.pdf.

.21 PCAOB Rule 3100 generally requires all registered public accounting firms to adhere to the PCAOB’s auditing and related professional practice standards, which encompass auditing, attestation, quality control, ethics, and independence standards, in connection with the preparation or issuance of any audit report for an issuer and in its auditing and related attestation practices. This rule also requires registered public accounting firms and their associated persons to comply with all applicable standards. Accordingly, if the PCAOB’s standards do not apply to an engagement or other activity of the firm, PCAOB Rule 3100, by its own terms, does not apply to that engagement or activity.

Interim Ethics Standards

.22 PCAOB Rule 3500T designates the provisions of the Code on integrity and objectivity as Interim Ethics Standards. Accordingly, in preparing or issuing an audit report, a registered public accounting firm and its associated persons should comply with ethics standards as described in Rule 102, Integrity and Objectivity (AICPA, Professional Standards, vol. 2, ET sec. 102), and interpretations and rulings thereunder, as in existence as of April 16, 2003, to the extent not superseded or amended by the PCAOB.

Interim Independence Standards

.23 PCAOB Rule 3600T designates the provisions of the Code regarding independence and existing standards and interpretations of the ISB as interim independence standards. This rule states that, in
connection with the preparation or issuance of any audit report, a registered public accounting firm and its associated persons shall comply with the following independence standards, to the extent not superseded or amended by the PCAOB:

- Rule 101, Independence (AICPA, Professional Standards, vol. 2, ET sec. 101), and interpretations and rulings thereunder, as in existence on April 16, 2003
- Interpretation No. 99-1
- ISB Interpretation No. 00-1, The Applicability of ISB Standard No. 1 When “Secondary Auditors” Are Involved in the Audit of a Registrant (AICPA, PCAOB Standards and Related Rules, PCAOB Standards, As Amended, “Independence Standards Board”)
- Interpretation No. 00-2, The Applicability of ISB Standard No. 1 When “Secondary Auditors” Are Involved in the Audit of a Registrant: An Amendment of Interpretation 00-1 (AICPA, PCAOB Standards and Related Rules, PCAOB Standards, As Amended, “Independence Standards Board”)

To the extent that the SEC’s rules are more or less restrictive than the PCAOB’s Interim Independence Standards, registered public accounting firms must comply with the more restrictive requirements.

### PCAOB Inspectors Observe Deficiencies in Independence Compliance and Controls

In October 2007, PCAOB Release 2007-010, Report on the PCAOB’s 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms (the report), discussed audit areas where inspectors observed significant or frequent deficiencies. One such area was independence compliance and quality controls. The following is a summary of the inspector’s observations:

- **Prohibited bookkeeping services.** The most common independence compliance deficiency the PCAOB inspectors observed was the performance of prohibited bookkeeping services. SEC rules prohibit auditors from maintaining or preparing accounting records, preparing source data underlying a company’s financial statements, and preparing the financial statements or footnotes that are filed with the SEC. The report notes that even working on a portion of a company’s financial statements or records impairs independence, including the following:
  - Preparing the tax provision
  - Maintaining the trial balance
  - Classifying items in the general ledger
  - Maintaining the fixed asset ledger
  - Preparing consolidation schedules
  - Preparing or posting journal entries

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1 International Standards Board (ISB) Standard No. 1, Independence Discussions with Audit Committees (AICPA, PCAOB Standards and Related Rules, PCAOB Standards, As Amended, “Independence Standards Board”); ISB Interpretation No. 00-1, The Applicability of ISB Standard No. 1 When “Secondary Auditors” Are Involved in the Audit of a Registrant (AICPA, PCAOB Standards and Related Rules, PCAOB Standards, As Amended, “Independence Standards Board”); and ISB Interpretation No. 00-2, The Applicability of ISB Standard No. 1 When “Secondary Auditors” Are Involved in the Audit of a Registrant: An Amendment of Interpretation 00-1 (AICPA, PCAOB Standards and Related Rules, PCAOB Standards, As Amended, “Independence Standards Board”), which are included in the following bulleted items, were superseded in August 2008 by PCAOB Rule 3526, Communication with Audit Committees Concerning Independence (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”).
Preparing source data (for example, developing fair values of intangible assets or calculating depreciation expense)

The report recognizes that many smaller companies do not have competent accounting personnel. Nevertheless, the client’s need for assistance does not exempt the auditor from the independence requirements. If the client needs assistance, the firm may consider referring the client to another firm. Note: the entity should not be associated with the accounting firm making the referral. If the audit firm receives a fee for making the referral, paragraph .01(C) of ET section 503, Commissions and Referral Fees (AICPA, Professional Standards, vol. 2), requires disclosure of the fee to the client. Local accountancy board regulations may impose additional requirements.

- Indemnification clauses. Inspectors also observed that some firms were using prohibited indemnification clauses in audit engagement letters. For years, the SEC staff position has been that limiting the auditor’s liability for the audit impairs objectivity. This position is stricter than Ethics Ruling No. 94, which allows the auditor to be indemnified for liability arising as a result of management misconduct, such as lying to, or concealing information from, the auditor.

- Quality control deficiencies. PCAOB Rule 3400T, Interim Quality Control Standards (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”) requires, by reference to the AICPA SEC Practice Section’s Requirements of Membership, that registered public accounting firms have policies and procedures in place to aid their compliance with applicable independence requirements of the AICPA, SEC, and ISB.

- Weak or nonexistent independence quality controls. The report also noted several instances of weak or nonexistent independence quality controls, including the following:
  - Incomplete, inadequate, or nonexistent policies and procedures for confirming firm professionals’ compliance with independence policies
  - Lack of procedures that monitor compliance with personal independence requirements set forth by partners and managers
  - Outdated or incomplete lists of restricted entities (issuer audit clients and their affiliates)
  - Lack of training on auditor independence

Inspectors also noted numerous instances where firms did not have policies and procedures to help ensure that firm professionals make and document their discussions with clients’ audit committees.

**GAO Independence Standard**

.26 CPAs, non-CPAs, government financial auditors, and performance auditors who audit federal, state, and local governments as well as not-for-profit and for-profit recipients of federal (and some state) grant and loan assistance should be familiar with the ethics and independence requirements of the Government Auditing Standards (GAS, also referred to as the Yellow Book). The GAO independence rules are in some cases very similar to the AICPA independence rules; however, in other cases, the GAO independence rules are more restrictive.

.27 Certain companies (issuers) subject to the Securities Exchange Act of 1934 may have an audit conducted in accordance with standards issued by both the PCAOB, as required by Sarbanes-Oxley, and the Comptroller General of the United States, as contained in GAS (for example, a bank that participates in federally-sponsored loan programs). For such entities, auditors must satisfy both sets of standards in conducting their work.

.28 In July 2007, the Comptroller General of the United States issued the 2007 revision of the Yellow Book, which superseded the 2003 edition. Chapters 23 of the Yellow Book address professional ethics and independence. In issuing the new Yellow Book, the GAO did not revise the substance of the independence and ethics rules.
The new Yellow Book is effective for (1) financial statement audits and attest engagements for periods beginning on or after January 1, 2008, and (2) performance audits beginning on or after January 1, 2008. The distinction between (1) and (2) is that (1) applies to the period under audit, whereas (2) applies to the engagement start date. Thus, an audit of financial statements for the period ended December 31, 2007 would be subject to the old (2003) Yellow Book, even though the audit is performed in 2008, whereas a performance audit would be subject to the new Yellow Book regardless of the period under audit.

The independence rules, in substance, are unchanged. For nonaudit services, they continue to require the auditor to observe two overarching principles to enable performance of such services. The revised Yellow Book has summarized the guidance into three distinct categories of nonaudit services. The categories and examples of each follow:

- **Nonaudit services that do not impair independence and do not require compliance with the supplemental safeguards.** Examples of these services include services that are considered to be “routine advice” as they typically are performed in conjunction with the audit (for example, limited advice on the implementation of internal controls or new accounting standards).

- **Nonaudit services that would not impair independence provided the auditor complies with the supplemental safeguards.** Examples of these services include certain limited bookkeeping, information technology or human resource assistance, or preparation of routine tax filings.

- **Nonaudit services that impair independence; compliance with supplemental safeguards will not overcome this impairment.** Examples of these services include posting entries to the general ledger, processing payroll that is material to the financial statements, or designing a financial reporting system. (Note: by their nature, these services violate one or both of the overarching principles discussed in the Yellow Book.)

On February 25, 2008, the Advisory Council on Government Auditing Standards met with the GAO staff in Washington, D.C., to discuss a possible project to revise its independence guidance. The GAO staff sought input on the following:

- Whether the GAO independence standards should be based on a risk-based conceptual framework (instead of a traditional rules-based model)
- Whether the GAO should clarify the meaning of personal, external, and organizational independence
- What should be done with the FAQs
- Independence impairments and governmental mandates

The July 2007 Yellow Book is available at www.gao.gov/govaud/ybk01.htm. Valuable guidance on applying the GAO independence rules is available in Answers to Independence Standard Questions in the form of FAQs, at www.gao.gov/govaud/d02870g.pdf. The FAQs remain in full effect with the issuance of the 2007 Yellow Book. The paragraph references in the FAQs are based on Amendment No. 3, Independence, of the June 2004 Government Auditing Standards (GAO-02-388G). In July 2007, the GAO issued Government Auditing Standards, July 2007 Revision (GAO-07-731G), which provides corresponding paragraph references to the 2007 version of the Yellow Book.

**On the Horizon**

**Proposed AICPA Ethics Interpretations and Rulings**

On August 13, 2007, the PEEC issued proposed Ethics Interpretation No. 101-17, “Networks and Network Firms,” under Rule 101, a proposal addressing the concept of a network firm. Under the proposal, an association of accounting firms is a network (and the firms within the network are network firms) if the firms in the association share one or more specified characteristics, such as profit sharing, common control, or the use of a common brand name in the firm name. Under a proposed, related interpretation, network firms would be required to maintain independence of certain attest clients of all firms in the network.
proposal is the PEEC’s latest effort to harmonize its ethics rules with those of the International Federation of Accountants (IFAC), which adopted a similar definition in 2006. Comments were due November 15, 2007. The exposure draft may be obtained at www.aicpa.org/download/ethics/August_13_2007_Exposure_Draft.pdf.

Among other things, some of the comments expressed the opinion that the use of a common brand name as part of the firm name should not, if that is the only condition satisfied, result in a firm being considered a network firm. The PEEC is considering whether in that situation any safeguards, such as inclusion of specific disclosures on a firm’s letterhead or Web site explaining the nature of the firm’s relationship to an association, could mitigate the appearance that a network exists. At this time, the PEEC continues to assess certain other issues related to the proposal (for example, description of what constitutes an “association”). The PEEC also may issue proposed revisions to a related ethics ruling, such as Ethics Ruling No. 179, “Practice of Public Accounting Under Name of Association or Group,” of ET section 591, Ethics Rulings on Other Responsibilities and Practices (AICPA, Professional Standards, vol. 2, ET sec. 591 par. .357–.358).

On May 15, 2007, the PEEC proposed Ethics Interpretation No. 102-7, “Other Considerations: Meeting the Objectives of the Fundamental Principles,” under Rule 102. In connection with that proposal, the PEEC also issued Proposed Framework for Meeting the Objectives of the Fundamental Principles. If adopted, the proposed framework would provide guidance to AICPA members who encounter situations that are not explicitly addressed by the Code. The framework is consistent with the IFAC Code of Ethics for Professional Accountants (the IFAC Code) and brings the AICPA Code closer to convergence with international standards. Similar to ET section 100.01, Conceptual Framework for AICPA Independence Standards (AICPA, Professional Standards, vol. 2), members would consider specific threats to complying with the rules of conduct, such as integrity and due care. As needed, the member would apply appropriate safeguards to eliminate or reduce those threats to an acceptable level. Comments on the proposal were due August 15, 2007. A PEEC task force made significant revisions to the draft framework based on the comments received, which also have been discussed by the PEEC in its open meetings this past year. The PEEC continues to consider the proposal at this time.

Other AICPA Projects

Immediate Family Member’s Participation in Retirement or Savings Plans

The PEEC formed a task force to consider whether existing independence guidance appropriately addresses the following scenario: a covered member’s immediate family member (for example, a spouse) participates in a retirement or savings plan that is an attest client or is sponsored by an attest client. The spouse’s employment with the client is permitted under the independence rules if the covered member is not a member of the attest team or able to influence the attest engagement. The task force has reached some tentative conclusions, discussed them with the PEEC, and is expected to recommend proposed changes to Ethics Interpretation No. 101-1, “Interpretation of Rule 101,” under Rule 101, Independence (AICPA, Professional Standards, vol. 2, ET sec. 101 par. .02), and Ethics Ruling No. 107, “Participation in Health and Welfare Plan Sponsored by Client,” of ET section 191, Ethics Rulings on Independence, Integrity, and Objectivity (AICPA, Professional Standards, vol. 2, ET sec. 191 par. .214–.215), at a future meeting.

XBRL and IFRS Task Forces

The PEEC formed a task force that will consider revising Ethics Interpretation No. 101-3 for two types of nonattest services that are expected to become more prevalent in the next several years: assisting clients with their adoption of Extensible Business Reporting Language (XBRL) and transitioning financial reporting from U.S. GAAP to IFRS. In the first phase, the task force will work jointly with members of the XBRL Assurance Task Force to consider whether to provide independence guidance to members assisting clients with XBRL-related services. In the second phase, the task force will examine how the rules apply when members help clients with tasks related to their adoption of IFRS.
International Ethics Convergence and Monitoring

38 The visibility of the IFAC Code in the U.S. has grown in recent years as business has become increasingly global and as the AICPA has begun the process of converging its Code with the IFAC guidance. Consequently, CPA firms of all sizes are being asked to confirm their compliance with global standards.

39 The following scenarios illustrate these points:

- A three-partner firm in Albany, N.Y., is the auditor for a beverage manufacturer. In a major acquisition, a Canadian company purchases the manufacturer. The new parent’s auditor asks the U.S. firm to confirm that it is independent of the new owner under international standards.

- A local firm is part of a global accounting association that is deemed, under international standards, to be a network. All firms in the network must be independent of the other firms’ audit and review clients in accordance with those standards. In fact, the network requires its members to meet global ethics standards for all multinational assurance engagements.

- A regional firm in southern California serves as auditor of a small Los Angeles-based software developer that acquires a company in Bangalore, India. The client’s significant vendors and its lenders expect to rely on the California firm’s audit report and, thus, expect the firm to meet global standards.

- A small firm’s client expands its business by opening a branch office in China. Lessors, vendors, and lenders in China ask the firm to audit the client’s financial information in accordance with international auditing standards, which will call for the firm to comply with international ethics standards.

40 In January 2008, the International Ethics Standards Board for Accountants (IESBA) approved its revised independence standard (Independence I project), which included a final definition of a public interest entity (PIE). The approved definition of a PIE is (1) a listed entity and (2) any other entity that a regulator or legislation has designated as a PIE or for which an audit is required (by law or regulation) to be conducted in compliance with the same independence requirements as listed entities (for example, in the U.S., this would include certain privately-owned financial institutions). In addition, firms and member bodies are encouraged to consider whether additional entities also should be treated as PIEs because they have a large number and wide range of stakeholders. The IESBA also approved an exception for partner rotation for firms who have “only a few people with the necessary knowledge and experience to serve as a key audit partner” of a PIE if (a) an independent regulator in the relevant jurisdiction provides an exemption from partner rotation in such circumstances and (b) the regulator has specified alternative safeguards, which are required to be applied.

41 In the U.S., this exception would cover certain small firms that audit SEC registrants and are subject to PCAOB inspection. As stated in the preceding paragraphs, the PEEC has undertaken a project to determine whether changes may be necessary to converge the AICPA and IESBA PIE definitions.

42 The IESBA proposed additional revisions to Section 290 of the IFAC Code, Independence—Audit and Review Engagements, and proposed Section 291, Independence—Other Assurance Engagements, in July 2007. The proposal expanded the guidance on internal audit services, the impact of significant fees to an accounting firm, and contingent fees. In May 2008, the IESBA re-exposed two elements of the draft proposal: (1) proposed requirements when a practitioner provides internal audit services to a public interest audit client and (2) safeguards required when the fees from a public interest audit client exceed 15 percent of the total fees of the firm. Comments on the second proposal were due August 31, 2007.

43 In July 2008, the IESBA issued another proposal intended to clarify the language of the IFAC Code (for example, use of “should” versus “must”). Comments on this proposal were due October 15, 2008. The IESBA has declared that it will not put forth any more proposals for a period of at least two years. This “quiet period” will allow member bodies (such as the AICPA) time to adapt their national codes to the new IFAC Code, which is expected to be issued in June 2009. If the new IFAC Code is released then, it would become
effective December 31, 2010, with earlier application encouraged. Certain transition provisions will be incorporated where requirements have been tightened.

**Three-Year Project Agenda**

.44 Other topics the PEEC has added to its agenda include contingent fees in tax matters, inadvertent violations, public interest entities, confidential client information, and client affiliates. In addition, the PEEC plans to develop the objectives and overall strategies to codify the Code and related guidance.

.45 The AICPA Professional Ethics Division maintains a three-year project agenda on its Web site that lists all current and future PEEC projects. The agenda can be found at www.aicpa.org/download/ethics/PEEC_Project_Agenda.pdf.

**New and Revised PCAOB Independence Rules**

.46 In August 2008, the SEC approved new PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence* (AICPA, *PCAOB Standards and Related Rules, Rules of the Board, “Rules”*), which supersedes the PCAOB’s existing interim standard, ISB Standard No. 1 and its interpretations. Auditors must comply with PCAOB Rule 3526, which builds on ISB Standard No. 1, before accepting a new audit engagement (this is a new requirement) and annually thereafter. The auditor must describe in writing to the audit committee all relationships between the auditor and the client (including affiliates of both) that reasonably could be thought to bear on independence, discuss these matters with the audit committee, and document the substance of that discussion. The new rule went into effect on September 30, 2008.

.47 The SEC also approved a revision to PCAOB Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles* (AICPA, *PCAOB Standards and Related Rules, Rules of the Board, “Rules”*), which permits an auditor to cease performing tax services for persons associated with a prospective audit client (that normally would be proscribed under PCAOB Rule 3523) prior to the beginning of the professional engagement period and still be considered independent. The revision became effective upon its approval by the SEC on August 22, 2008.

**Status of DOL Request for Comments on Independence Rules Pertaining to Employee Benefit Plan Audits**

.48 On September 11, 2006, the DOL issued a request for information (RFI) seeking public comment on the advisability of the DOL amending the auditor independence rules for employee benefit plan audits subject to the Employee Retirement Income Security Act of 1974 (ERISA). This is the first time the DOL has considered its independence requirements since DOL Interpretive Bulletin 75-9 (29 CFR 2509.75-9), *Independence of Employee Benefit Plan Accountants*, was issued in 1975. The DOL RFI notes that the current DOL requirements conflict with AICPA and SEC independence requirements and have caused confusion among practitioners. The comment period closed on December 11, 2006. To date, the DOL has not issued a response to the feedback it received regarding its RFI.

.49 The DOL’s RFI can be found at http://ebpaqc.aicpa.org/NR/rdonlyres/7EA13B14-C1AE-42EF-9FD1-B1B1353A962F/0/DOL_Auditor_Independence_RFI.pdf. The comment letters received by the DOL can be found at www.dol.gov/ebsa/regs/cmt-IndPlanAccountants.html.
Resource Central

Publications

.50 Practitioners may find the following publications useful when considering independence and ethics issues:

- *Independence Compliance: Checklists and Tools for Complying With AICPA and GAO Independence Requirements* (product no. 006627kk)
- *Independence Compliance: Checklists and Tools for Complying with AICPA, SEC, and PCAOB Independence Requirements* (product no. 006630kk)

AICPA reSOURCE: Accounting and Auditing Literature

.51 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm’s needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to the AICPA’s latest *Professional Standards, Technical Practice Aids, Audit and Accounting Guides* (more than 20), Audit Risk Alerts (more than 15), and *Accounting Trends & Techniques*. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Continuing Professional Education

.52 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs. Among the available titles, the following courses pertain to independence and ethics:

- *Ethics for Tax Practice Professionals: Circular 230 and the SSTSs* (product no. 738702HSkk [CD-ROM], 158700kk [online])
- *Ethics: Non-Attest Services, Integrity and Objectivity* (product no. 739412HSkk [CD-ROM], 159412kk [online])
- *Independence* (product no. 739178HSkk [CD-ROM], 159178kk [online])
- *Selected Topics in Professional Ethics* (product no. 738383HSkk [CD-ROM], 158383kk [online])
- *Professional Ethics: 2008 Update* (product no. 739430HSkk [CD-ROM], 159430kk [online])
- *Professional Ethics: AICPA’s Comprehensive Course* (product no. 738392HSkk [CD-ROM], 732311kk [text])
- *Professional Ethics: Complying With the GAO Rules* (product no. 739440HSkk [CD-ROM], 159440kk [online])
- *Professional Ethics for CPAs in Business & Industry* (product no. 738900HSkk [CD-ROM], 158900kk [online])
- *Real World Business Ethics for CPAs in A&A: How Will You React?* (product no. 7336010kk [text])
- *Real World Business Ethics for CPAs in Business & Industry: How Will You React?* (product no. 733591kk [text])

.53 The AICPA interactive CD-ROM course on independence, titled *Independence*, teaches the AICPA and SEC independence rules and qualifies for eight hours of CPE credits. See www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/Ethics/PRDOVR~PC-739155HS/PC-739155HS.jsp.

.54 Visit www.cpa2biz.com for a complete list of CPE courses.
Online CPE

.55 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz, is AICPA's flagship online learning product. AICPA members pay $180 for a new subscription and $149 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1- and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics that address ethics and independence issues include the following:

- 2008 Annual A&A Update—Various Issues Affecting Auditors
- Ethics: AA&C LLP—Accounting Firm Practice Development Committee
- Ethics: BAN&K Advisory Services LLC—You are the Audit Partner
- Ethics: Department of Enforcement—You are the Accounting Investigator
- Ethics: Forensic Review Services LLC—You are the Forensic Auditor
- Ethics: Incisive Lasers Corporation—You are the Outside Counselor
- Ethics: Megatron Corp.—You are the Corporate Controller
- Ethics: Military Communications Corp.—You are the Outside Tax Advisor
- Ethics: Pointer Electronics, Inc.—You are the Audit Partner
- Ethics: Precious Mining Inc.—You are the Audit Committee Chair
- Ethics: Radar One, LLP—You are the Amended Return Preparer
- Ethics: Scrap Metal Aggregators, Inc.—You are the Tax Return Preparer
- Ethics: Superlative Software, Corp.—You are the CFO
- In a CPA’s Professionalism We Must Trust
- Yellow Book: Ethical Principles and General Standards

.56 To register or learn more, visit www.cpa2biz.com.

Webcasts

.57 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession’s leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.58 The CFO Quarterly Roundtable Series, brought to you each calendar quarter via webcast, covers a broad array of “hot topics” that successful organizations employ and subjects that are important to the CFO’s personal success. From financial reporting, budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.59 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession’s leading experts on what is “hot” at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you “plugged in” to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.60 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.
Hotlines

Ethics Hotline

.61 The AICPA offers an Ethics Hotline. Members of the AICPA’s Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code. You can reach the Ethics Hotline at (888) 777-7077. Send e-mail inquiries to ethics@aicpa.org.

Accounting and Auditing Technical Hotline

.62 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA’s Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. Beginning January 14, 2008, hotline hours were extended so that the hotline is now available from 9 a.m. to 8 p.m. on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/.

AICPA Governmental Audit Quality Center

.63 The Governmental Audit Quality Center (GAQC) is a firm-based, voluntary membership center designed to help CPAs meet the challenges of performing quality audits in this unique and complex area. The GAQC’s primary purpose is to promote the importance of quality governmental audits and the value of such audits to purchasers of governmental audit services. The GAQC also offers resources to enhance the quality of a firm’s governmental audits.

.64 The mission of the GAQC is to do the following:

- Raise awareness about the importance of governmental audits
- Serve as a comprehensive resource provider on governmental audits for member firms
- Create a community of firms that demonstrates a commitment to governmental audit quality
- Provide center members with an online forum tool for sharing best practices and discussing audit, accounting, and regulatory issues
- List member firms to enable purchasers of governmental audit services to identify firms that are members
- Provide information about the center’s activities to other governmental audit stakeholders

.65 For more information about the GAQC visit http://gaqc.aicpa.org.

The Center for Audit Quality

.66 The Center for Audit Quality (CAQ), which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ’s mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession’s core values of integrity, objectivity, honesty, and trust.

.67 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit http://thecaq.aicpa.org.
AICPA Employee Benefit Plan Audit Quality Center

.68 The AICPA Employee Benefit Plan Audit Quality Center (EBPAQC) is a firm-based, voluntary membership organization for firms that perform or are interested in performing ERISA employee benefit plan audits. The EBPAQC was established to promote the quality of employee benefit plan audits.

.69 To achieve this goal, the EBPAQC has created a community of firms that demonstrate a commitment to employee benefit audit quality, and supports those firms by doing the following:

- Providing members with timely communication of regulatory developments, best practices guidance, and technical updates
- Providing members with an online community forum for sharing best practices as well as discussions on audit, accounting, and regulatory issues
- Maintaining relationships with, and acting as a liaison to, the DOL on behalf of member firms
- Providing center members with a marketing toolkit to facilitate promotion of their membership in the center
- Providing information about the center’s activities to other employee benefit plan stakeholders

.70 The increasing complexity of employee benefit plan auditing and increased scrutiny by the DOL have resulted in a significant number of changes and issues for auditing firms and CPAs in general. Firms and CPAs will benefit from the assistance of the center as a resource for improving employee benefit plan audit quality.

.71 For more information about the EBPAQC, visit http://ebpaqc.aicpa.org.

Industry Web Sites

.72 The Internet covers a vast amount of information that may be valuable to auditors, including current industry trends and developments. Some of the more relevant sites for auditors include those shown in the following table:

<table>
<thead>
<tr>
<th>Web Site Name</th>
<th>Content</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>American Institute of CPAs (AICPA)</td>
<td>Summaries of recent auditing and other professional standards as well as other AICPA activities</td>
<td><a href="http://www.aicpa.org">www.aicpa.org</a></td>
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<td><a href="http://www.cpa2biz.com">www.cpa2biz.com</a></td>
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<td><a href="http://www.ifrs.com">www.ifrs.com</a></td>
</tr>
<tr>
<td>AICPA Professional Ethics Executive Committee (PEEC)</td>
<td>AICPA Code of Professional Conduct (Code); PEEC standards setting projects and meeting information; information on the ethics enforcement process, including discipline actions; as well as an array of other resources</td>
<td><a href="http://www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/">www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/</a></td>
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</tr>
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<tbody>
<tr>
<td>Department of Labor (DOL)</td>
<td>DOL Regulation 2509.75-9, Interpretive bulletin relating to guidelines on independence of accountant retained by Employee Benefit Plan, and contact information</td>
<td><a href="http://www.dol.gov/">www.dol.gov/</a></td>
</tr>
<tr>
<td>Government Accountability Office (GAO)</td>
<td>Government Auditing Standards (GAS) independence standard, frequently asked questions (FAQs) on independence, slide presentation on independence, and contact information</td>
<td><a href="http://www.gao.gov/govaud/ybk01.htm/">www.gao.gov/govaud/ybk01.htm/</a></td>
</tr>
<tr>
<td>International Federation of Accountants (IFAC)</td>
<td>Pronouncements, projects, and key contacts of the International Ethics Standards Board for Accountants (IESBA), including the IESBA’s Code of Ethics for Professional Accountants (IESBA Code) and the July 2008 exposure draft of the revised IESBA Code</td>
<td><a href="http://www.ifac.org/Ethics/">www.ifac.org/Ethics/</a></td>
</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
<td>Information on accounting and auditing activities of the PCAOB, including those on independence</td>
<td><a href="http://www.pcaob.org">www.pcaob.org</a></td>
</tr>
<tr>
<td>Securities and Exchange Commission (SEC)</td>
<td>Information from the Office of the Chief Accountant for accountants and auditors, including independence; current SEC rulemaking; final rule releases 33-8183A and 33-8183, Strengthening the Commission’s Requirements Regarding Auditor Independence; and key contact information</td>
<td><a href="http://www.sec.gov">www.sec.gov</a></td>
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.73 This Audit Risk Alert replaces Independence and Ethics Alert—2007/08.

.74 The Audit Risk Alert Independence and Ethics Developments is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year’s Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to dridge@aicpa.org or write to

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Appendix—Digest of the AICPA Independence Rules

A plain-English description of the AICPA independence rules follows. The purpose of this section is to help you to understand independence requirements under the AICPA Code of Professional Conduct (Code) and, if applicable, other rule-making and standard-setting bodies. Independence generally implies one's ability to act with integrity and exercise objectivity and professional skepticism. The AICPA and other rule-making bodies have developed rules that establish and interpret independence requirements for the accounting profession. We use the term rules broadly to also mean standards, interpretations, rulings, laws, regulations, opinions, policies, or positions. This guide discusses in plain English the independence requirements of the principal rule-making bodies in the United States so you can understand and apply them with greater confidence and ease.

This section of the alert is intentionally concise, so it does not cover all the rules, some of which are complex, nor does it cover every aspect of the rules herein. Nonetheless, this guide should help you identify independence issues that may require further consideration. Therefore, you should always refer to the rules directly, in addition to your firm’s policies on independence, for complete information.

Conventions and Key Terms Used

The following are some of the conventions used in this section of the alert:

- The word Note in boldface italics emphasizes important points, highlights applicable government regulations, or indicates that a rule change may soon occur.

We describe the rules of the Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB)—that is, those that apply to audits of public companies—in boxed text (like this one) and provide citations to specific rules. Generally, we provide these descriptions where the SEC or PCAOB impose additional requirements, or where the SEC and PCAOB rules otherwise differ from the AICPA rules.

This section uses the following key terms:

- **Client (or attest client).** An entity with respect to which independence is required.

- **Firm.** A form of organization permitted by law or regulation (whose characteristics conform to the resolutions of the AICPA Council) that is engaged in the practice of public accounting.

What Is Independence?

Independence is defined in ET section 100.01, Conceptual Framework for AICPA Independence Standards (AICPA, Professional Standards, vol. 2), referred to herein as the conceptual framework, as follows:

**Independence of mind.** The state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

**Independence in appearance.** The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team had been compromised.

These definitions reflect the longstanding professional requirement that members who provide services to entities for which independence is required be independent both in fact (that is, “of mind”) and in appearance.
What Should I Do If No Specific Guidance Exists on My Particular Independence Issue?

The “Other Considerations” section of Interpretation No. 101-1 “Interpretation of Rule 101,” under Rule 101, Independence (AICPA, Professional Standards, vol. 2, ET sec. 101 par .02), recognizes that it is impossible for the Code to identify all circumstances in which the appearance of independence might be questioned. The conceptual framework is referred to in Interpretation No. 101-1 of the Code.

Specifically, Interpretation No. 101-1 requires that members use the risk-based approach described in the conceptual framework when making independence decisions involving matters that are not specifically addressed in the independence interpretations and rulings in the Code. Where threats to independence are not at an acceptable level, safeguards must be applied to eliminate the threats or reduce them to an acceptable level. In cases where threats to independence are not at an acceptable level, thereby requiring the application of safeguards, the threats identified and the safeguards applied to eliminate the threats or reduce them to an acceptable level must be documented.

The conceptual framework provides a valuable tool to help you comply with the requirement in the “Other Considerations” section to evaluate whether a specific circumstance that is not addressed in the Code would pose an unacceptable threat to your independence.

When Is Independence Required, and Who Sets the Rules?

AICPA Professional Standards require your firm, including the firm’s partners and professional employees, to be independent in accordance with Rule 101, Independence (AICPA, Professional Standards, vol. 2, ET sec. 101), of the Code whenever your firm performs an attest service for a client. Attest services include the following:

- Financial statement audits
- Financial statement reviews
- Other attest services as defined in the Statements on Standards for Attestation Engagements

Performing a compilation of a client’s financial statements does not require independence. However, if a nonindependent firm issues such a compilation report, the report must state, “I am (we are) not independent with respect to XYZ Company.”

You and your firm are not required to be independent to perform services that are not attest services (for example, tax preparation or advice, or consulting services, such as personal financial planning) if they are the only services your firm provides to a particular client.

Note: You should familiarize yourself with your firm’s independence policies, quality control systems, and list or database of attest clients.

In Addition to the AICPA, Who Else Sets Independence Rules?

Many clients are subject to oversight and regulation by governmental agencies. For example, the Government Accountability Office (GAO) sets independence rules that apply to entities audited under Government Auditing Standards (also referred to as the Yellow Book). For these clients (and others, such as those subject to regulation by the SEC or Department of Labor [DOL]), you and your firm also must comply with the independence rules established by those agencies.

The SEC regulates public companies and establishes the qualifications of independent auditors. This section refers to these independence rules as SEC rules.

The PCAOB, a private standards-setting body whose activities are overseen by the SEC, is authorized to set auditing, attestation, quality control, ethics, and independence standards for accounting firms that audit

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1 See paragraph .19 of AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2).

2 This includes companies that are registered with or are otherwise regulated by the United States Securities and Exchange Commission (SEC) or companies that file audited financial statements with the SEC, including foreign filers.
public companies. The PCAOB adopted interim ethics standards based on the following provisions of the Code: Rule 102, Integrity and Objectivity (AICPA, Professional Standards, vol. 2, ET sec. 102); Ethics Rule 101; and interpretations and rulings under those rules as of April 16, 2003. It also adopted International Standards Board (ISB) Standards. To the extent that the SEC’s rules are more or less restrictive than the PCAOB’s interim independence standards, registered public accounting firms must comply with the more restrictive requirements.

In addition to its detailed rules, the SEC looks to its general standard of independence and four basic principles to determine whether independence is impaired. The general standard is an appearance standard that considers whether a reasonable investor with knowledge of all relevant facts and circumstances would conclude that an accountant is independent.

Under the four basic principles, an auditor cannot
1. function in the role of management,
2. audit his or her own work,
3. serve in an advocacy role for the client, or
4. have a mutual or conflicting role with the client.

Other organizations that establish independence requirements that may be applicable to you and your firm include the following:
- State boards of accountancy
- State CPA societies
- Federal and state agencies

You should contact these organizations directly for further information.

Note: Generally, the AICPA independence rules will apply to you in all situations involving an attest client. If an additional set of rules governing an engagement also applies, you should comply with the most restrictive rule or the most restrictive portions of each rule.

Once you determine that your firm provides attest services to a client and which rules apply, the next step is to determine how the rules apply to you.

Applying the Rules—Covered Members and Other Firm Professionals

How Do the Independence Rules Apply to Me?

Whenever you are a covered member, you become subject to the full range of independence rules with regards to a specific client. You are a covered member if you are
1. an individual on the client’s attest engagement team;
2. an individual in a position to influence the client’s attest engagement;
3. a partner or manager who provides more than 10 hours of nonattest services to the attest client;
4. a partner in the office in which the lead attest engagement partner primarily practices in connection with the client’s attest engagement;
5. the firm, including the firm’s employee benefit plans; or
6. an entity whose operating, financial, or accounting policies can be controlled\(^3\) by any of the individuals or entities described in items 1–5 or by two or more such individuals or entities if they act together.

The SEC uses the term *covered person*\(^4\) to describe the individuals in a firm who are subject to SEC independence rules. This term is largely consistent with the AICPA’s term *covered member*. The only difference between the two definitions is that of classification. The AICPA considers consultants to be in a position to influence the engagement (the SEC uses the term *chain of command*), whereas the SEC considers these persons to be on the attest engagement team. Overall, the definitions are the same.

*Note:* This alert uses the term *covered member* (and *covered person* with respect to SEC rules) extensively in explaining the *personal* independence rules (for example, rules that apply to you and your family’s loans, investments, and employment). Therefore, it is important that you understand these terms before proceeding. Also, remember to check your firm’s policies to determine whether they are more restrictive than the AICPA or SEC rules.

**Do Any of the Rules Apply to Me If I Am Not a Covered Member?**

Yes, these rules apply in certain circumstances, even if you are not a covered member. Due to their magnitude, two categories of relationships with a client impair independence even if you are not a covered member. These relationships are defined as follows:

- Director, officer, or employee (or in any capacity equivalent to a member of management) of the client, promoter, underwriter, voting trustee of the client, or trustee of any of the client’s employee benefit plans
- Owner of more than 5 percent of an attest client’s outstanding equity securities (or other ownership interests)

The independence rules prohibit these relationships if you are a partner or professional employee in a public accounting firm.

**What If I Was Formerly Employed by a Client or I Was a Member of the Client’s Board of Directors?**

You must be aware of a number of things, including the following:

1. You may not participate in the client’s attest engagement, or be in a position to influence the engagement, for any periods covering the time that you were associated with the client. So, for example, if you worked for the client in 2007, you would be prohibited from serving on the client’s audit engagement for the fiscal year 2007 financial statements. You also could not serve in a position that would allow you to influence the fiscal 2007 engagement. For example, you could not directly or indirectly supervise the audit engagement partner.

2. Before becoming a covered member, you must
   
   a. terminate any relationships with the client as described in Ethics Interpretation No. 101-1,\(^5\)
   b. dispose of all financial interests\(^6\) in the client,

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\(^3\) As defined by generally accepted accounting principles for consolidation purposes.

\(^4\) See Rule 2-01(f)(11). Also see *Discussion of Rule 2-01, Covered persons in the firm*, in the SEC’s Final Rule Release (Section IV [H][9]).

\(^5\) This includes the director, officer, employee, or in any capacity equivalent to that of a member of management, promoter, underwriter, or voting trustee, or trustee for the entity’s pension and profit-sharing trust.

\(^6\) See the “When Do My (or My Family’s) Financial Interests Impair Independence?” section in this alert.
c. collect and repay all loans to or from the client (except those specifically permitted or grandfathered),

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d. cease active participation in the client’s employee benefit plans (except for benefits under the Consolidated Omnibus Budget Reconciliation Act of 1985), and

e. liquidate or transfer any vested benefits in the client’s retirement plans.

What Rules Apply If I Am Considering Employment With an Attest Client?

If an attest client offers you employment, or you seek employment with an attest client, you may need to take certain actions. If you are on that client’s attest engagement team or can otherwise influence the engagement, you must promptly report any employment negotiations with the client to the appropriate person in your firm. You cannot participate in the engagement until your negotiations with the client end.

What If I Accept Employment or a Board Position With an Attest Client?

Being employed by a client or a member of the client’s board of directors impairs independence. However, even if you leave your firm to take a position with a client, independence still may be affected. This would be the case if you accept a key position with the client, which means that you prepare financial statements or accounting records or are otherwise able to influence the client’s statements or records. A few examples of “key positions” are controller, chief financial officer, or treasurer. Remember that the substance, and not only the position title, determines whether a position is considered key or not.

If you meet the following conditions, having a key position with a client will not impair your firm’s independence:

• The amounts the firm owes you (capital balance or retirement benefits) are based on a fixed formula and are not material to the firm.

• You cannot influence the firm’s operations or financial policies.

• You do not participate or appear to participate in the firm’s business or professional activities.

Your firm must consider whether it should apply additional procedures to ensure that your transition to the client has not compromised the firm’s independence and that independence will be maintained going forward. Some things the firm should consider are

• whether you served on the engagement team and for how long,

• positions you held with the firm and your status,

• your position and status with the client, and

• the amount of time that has passed since you left the firm.

Based on these factors, the firm may decide to

• adjust the audit plan to reduce the risk that your knowledge of the plan could lessen the audit’s effectiveness,

• reconsider the successor engagement team to ensure it has sufficient stature and experience to deal effectively with you in your new position, or

• perform an internal technical review of the next attest engagement to determine whether engagement personnel exercised the appropriate level of professional skepticism in evaluating your work and representations. 8

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8 An objective professional with the appropriate stature and expertise should perform this review and the firm should take any recommendation(s) that result from the review.
Under SEC rules, if a former partner will be in an “accounting role” or “financial reporting oversight role” with an SEC audit client, he or she may not have the following:

- A capital balance with the firm
- A financial arrangement with the firm (for example, retirement benefits) that is not fully funded by the firm
- Influence over the firm’s operations or financial policies

The SEC uses the terms accounting role and financial reporting oversight role in its rules; taken together, these terms are consistent with the AICPA term key position. The SEC also requires a one-year “cooling-off period” for members of the audit engagement team who assume a financial reporting oversight role with that client. In other words, if an engagement team member who participated on the audit of the current (or immediately preceding) fiscal year goes to work for a client, the firm’s independence would be impaired.

Only members who have provided fewer than 10 hours of audit, review, or other attest services to the client (and did not serve as either the lead or concurring partner for the client) are not considered to be members of the audit engagement team for purposes of this rule.

This rule applies to the audit client and its consolidated entities.

Applying the Rules—Family Members

When Is My Family Subject to the Rules?

If you are a covered member with respect to a client, members of your immediate family (your spouse—or equivalent—and your dependents) generally must follow the same rules as you. For example, your spouse’s investments must be investments that you could own under the rules. This rule applies even if your spouse keeps the investments in his or her own name or with a different broker.

This general rule has two exceptions:

1. Your immediate family member’s employment with a client would not impair your firm’s independence, provided he or she is not in a key position.

2. Immediate family members of certain covered members may invest in a client through an employee benefit plan (for example, retirement or savings account), provided the plan is offered equitably to all similar employees. The covered members whose families may invest in this way are the following:
   - Partners and managers who provide only nonattest services to the client
   - Partners who are covered members only because they practice in the same office where the client’s lead attest partner practices in connection with the engagement

In other words, immediate family of individuals on the attest engagement team or of those who can influence the attest engagement team may not invest in a client under any circumstances.

Under SEC rules, the immediate family of certain covered persons may have financial interests in SEC audit clients only if such interests are an unavoidable consequence of their participation in an employee compensation or benefit plan. This means that if nonclient investments are available through the plan, the immediate family member must choose those investments.

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9 Accounting role or financial reporting role means a role in which a person is in a position to or does (1) exercise more than minimal influence over the contents of the accounting records or anyone who prepares them or (2) exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of a board of directors or similar management or governing body, chief executive officer, president, chief financial officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, vice president of marketing, or any equivalent position.
What About My Other Close Relatives?

The close relatives (siblings, parents, and nondependent children) of covered members are subject to some employment and financial restrictions. Your close relative’s employment by a client in a key position impairs independence, except for covered members who provide only nonattest services to a client.

Rules pertaining to your close relative’s financial interests differ depending on why you are considered a covered member:

- If you are a covered member because you participate on the client’s attest engagement team, your independence would be considered to be impaired if you are aware that your close relative has a financial interest in the client that either
  - was material to your relative’s net worth, or
  - enables the relative to exercise significant influence over the client.

- If you are a covered member because you are able to influence the client’s attest engagement or are a partner in the office in which the lead attest engagement partner practices in connection with the engagement, your independence will be impaired if you are aware that your close relative has a financial interest in the client that
  - is material to your relative’s net worth, and
  - enables your relative to exercise significant influence over the client.

Under SEC rules, your close family members include your spouse (or equivalent), dependents, parents, nondependent children, and siblings. If you are a covered person, your independence is affected if your close family member

- has an accounting role or financial reporting oversight role with the client (for example, the family member is a treasurer, chief financial officer, accounting supervisor, or controller), or
- owns more than 5 percent of a client’s equity securities or controls the client.

In addition, independence is considered to be impaired if any partner’s close family member controls a client.

Financial Relationships

When Do My (or My Family’s) Financial Interests Impair Independence?

This section discusses various types of financial relationships and how they affect independence. Although this section focuses on how these rules apply to you and your family, keep in mind that your firm also is subject to the financial relationship rules because firms are included in the AICPA definition of covered member.

As a covered member, you (and your spouse—or equivalent—and dependents) are not permitted to have the following:

- A direct financial interest in that client, regardless of how immaterial it would be to your net worth
- A material indirect financial interest in that client

Note: The Code does not define or otherwise provide guidance on determining materiality. In determining materiality, you should apply professional judgment to all relevant facts and circumstances and refer to applicable guidance in the professional literature. Both qualitative and quantitative factors should be considered.
In addition, if you commit to acquire a direct financial interest in a client, your independence would be impaired. For example, if you sign a stock subscription agreement with the client, your independence would be considered impaired as soon as you sign the agreement.

Examples of financial interests include shares of stock, mutual fund shares, debt security issued by an entity, partnership units, stock rights, options or warrants to acquire an interest in a client, or rights of participation, such as puts, calls, or straddles.

Direct financial interests are financial interests that are

1. owned by you directly;
2. under your control; or
3. beneficially owned\(^\text{10}\) by you through an investment vehicle, estate, trust, or other intermediary if you can either
   a. control the intermediary, or
   b. have the authority to supervise or participate in the intermediary’s investment decisions.

For example, if you invest in a participant directed 401(k) plan, whereby you are able to select the investments held in your account or are able to select from investment alternatives offered by the plan, you would be considered to have a direct financial interest not only in the 401(k) plan but also in the investments held in your account.

You also have a direct financial interest in a client if you have a financial interest in a client through one of the following:

- A partnership, if you are a general partner
- A Section 529 savings plan, if you are the account owner
- An estate, if you serve as an executor and meet certain other criteria
- A trust, if you serve as the trustee and meet certain other criteria

For example, suppose you are a covered member with respect to ABC Co. and you are also a general partner of XYZ Partnership. XYZ Partnership owns shares in ABC Co. Under the independence rules, you would be deemed to have a direct financial interest in ABC, which would impair your independence, regardless of materiality.

An indirect financial interest arises if you have a financial interest that is beneficially owned through an investment vehicle, estate, trust, or other intermediary and you can neither control the intermediary nor have the authority to supervise or participate in the intermediary’s investment decisions.

For example, if you invest in a defined contribution plan that is not participant directed and you have no authority to supervise or participate in the plan’s investment decisions, you would be considered to have an indirect financial interest in the underlying plan investments, in addition to a direct financial interest.

\textit{Note}: Ethics Interpretation No. 101-15, “Financial Relationships,” under Rule 101, Independence (AICPA, Professional Standards, vol. 2, ET sec. 101 par. 17), of the Code (effective December 31, 2005), provides extensive examples of various types of financial interests and whether they should be considered to be direct or indirect financial interests, including investments in mutual funds, retirement and savings plans, Section 529 plans, trusts, partnerships, and insurance products.

\(^{10}\) A financial interest is beneficially owned if an individual or entity is not the record owner of the interest, but has a right to some or all of the underlying benefits of ownership. These benefits include the authority to direct the voting or the disposition of the interest or to receive the economic benefits of the ownership of the interest.
The SEC classifies your investment in a client held through another entity (the intermediary) as direct if either of the following is true:
- You participate in the intermediary’s investment decisions or have control over them.
- The investment in the client by the intermediary (which is not a diversified mutual fund) represents 20 percent or more of the value of its total investments.

If neither of the preceding applies, your investment in a client through another entity would normally be considered to be an indirect financial interest in that client.

**What If My Immediate Family or I Receive a Financial Interest as a Result of an Inheritance or a Gift?**

If, due to an unexpected event, you or members of your immediate family receive a financial interest in an attest client that would impair your independence, you may qualify under an exemption in the rules if you meet the following criteria:
- The financial interest was unsolicited.
- You dispose of the interest as soon as practicable— but no later than 30 days after you become aware of it and have the right to dispose of it.
- If you do not have the right to dispose of the interest (for example, as in the case of stock options or restricted stock), you do not participate in the attest engagement for the client.

**What Are the Rules That Apply to My Mutual Fund Investments (and Those of My Family) If My Firm Audits Those Mutual Funds?**

If you are a covered member with respect to a mutual fund attest client of your firm, and you or your immediate family own shares in the fund, you have a direct financial interest in the fund client.

The SEC rules also prohibit the firm and covered persons and their immediate family members from having any financial interest in an entity (even one that is not a client) that is part of an investment company complex that includes an audit client.

**Which Rules Pertain to My Mutual Fund Investments (and Those of My Family) If My Firm Audits Companies Held in Those Mutual Funds?**

Financial interests that you and your immediate family have in clients through a mutual fund are considered to be indirect financial interests in those clients unless the fund is a diversified mutual fund.

If a mutual fund is diversified, and you or your immediate family, or both, own 5 or fewer percent of its outstanding shares, the fund’s holdings in clients for which you are a covered person will not be considered material indirect financial interests in those clients. Thus, you would be relieved of the burden of having to monitor whether, and to what degree, the fund invests in audit clients for which you are a covered person.

If the fund is not diversified, or you or your family, or both, own more than 5 percent of the fund’s equity, you should treat the fund’s holdings as indirect financial interests.

For example, suppose ABC Mutual Fund, a nondiversified mutual fund, owns shares in a client, XYZ, and
- ABC Mutual Fund’s net assets are $10,000,000;
- your shares in ABC Mutual Fund are worth $50,000;
- ABC Mutual Fund has 10 percent of its assets invested in XYZ; and
- your indirect financial interest in XYZ is $5,000 ($50,000 x .10).
If $5,000 is material to your net worth, independence would be considered to be impaired.

**May I Have a Joint Closely Held Investment With a Client?**

As a covered member, if you or the client, individually or collectively, control an investment, that investment is considered to be a joint closely held investment. If this joint closely held investment is material to your net worth, independence would be considered to be impaired. In this rule, *client* includes certain persons associated with the client, such as officers, directors, or owners who are able to exercise significant influence over the client.

The SEC rules prohibit you and your immediate family from having a joint business venture with a client or with persons associated with the client in a decision-making capacity (meaning officers, directors, or substantial shareholders) regardless of whether or not the venture is material to your net worth. The SEC believes that these joint ventures, whether material or not, cause the client and the audit firm to have mutuality of interests, which impairs independence.

**May My Family or I Borrow Money From or Lend Money to a Client?**

If you are a covered member with respect to an attest client, you and your immediate family may not have a loan to or from the following:

- The client
- An officer or director of the client
- An individual holding 10 percent or more of the client’s outstanding equity securities (or other ownership interests)

This rule has certain exceptions. First, covered members are permitted to have specific loans from financial institution attest clients. They include the following:

- Car loans and leases collateralized by the vehicle
- Credit card and overdraft reserve account balances that are kept current and do not exceed $10,000 (by payment due date, including any grace period)
- Passbook loans fully collateralized by cash deposits at the same financial institution
- Loans fully collateralized by an insurance policy

In addition, if you have a loan from a client financial institution (a bank, for example) that meets certain criteria, your loan may be “grandfathered” (that is, you may be allowed to keep it). For your loan to be grandfathered, you must have obtained it under normal lending procedures, terms, and requirements. The following loans may be grandfathered:

- Home mortgages
- Other secured loans
- Unsecured loans that are immaterial to your net worth

Generally speaking, a loan may be grandfathered if you obtained it before

- you became a covered member with respect to the client,
- the financial institution became a client, or
- the client acquired the loan.

To maintain your loan’s grandfathered status, you must keep the loan current (make timely payments according to the loan agreement). Also, you cannot renew or renegotiate the terms of the loan (for example,
the interest rate or formula) unless the change was part of the original agreement (for example, an adjustable rate mortgage).

The SEC rules differ from the AICPA rules in that secured loans (other than a mortgage on your primary residence) and immaterial unsecured loans may not be grandfathered.

May I Have a Brokerage Account With a Client?

The AICPA rules indicate that for independence to be maintained, a covered member whose assets are held by a broker-dealer client must not receive any preferential treatment or terms, and any assets that are subject to risk of loss must be immaterial to the covered member’s net worth. In addition, margin accounts may be subject to the loan rules.\(^\text{11}\)

Under the SEC rules, you may have a brokerage account with a client if your account (1) only holds cash or securities and (2) is fully insured by the Securities Investor Protection Corporation.

May I Have a Bank Account With a Client?

As a covered member, you may have a bank account with a client financial institution (for example, checking, savings, or money market accounts and certificates of deposit) if your deposits are fully insured by state or federal deposit insurance agencies or uninsured amounts are not material to your net worth.\(^\text{12}\)

The SEC prohibits covered persons and their immediate families from having bank account balances in excess of Federal Deposit Insurance Corporation (FDIC) insurance limits; that is, deposits in excess of FDIC limits are considered to impair independence, even if immaterial to you and your family.\(^\text{13}\)

May I Have an Insurance Policy With a Client?

The AICPA rules indicate that in order to maintain independence, a covered member must not receive any preferential treatment or terms when purchasing an insurance policy from a client. If the policy has an investment option, the financial interest rules must be applied.

The SEC prohibits covered persons and their immediate family members from owning an individual insurance policy issued by a client unless both of the following criteria are met:

- He or she obtained the policy before the professional became a covered person.
- The likelihood of the insurer becoming insolvent is remote.

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\(^\text{11}\) See the preceding question “May My Family or I Borrow Money From or Lend Money to a Client?” in the section titled “Financial Relationships.”

\(^\text{12}\) Both AICPA and SEC rules permit a practical exception for firms that maintain deposits exceeding insured limits when the likelihood of the financial institution experiencing financial difficulties is considered remote.

\(^\text{13}\) The SEC treats money market funds (as opposed to money market accounts) as mutual funds for the purposes of their rules. Also, see Rule 2-01(c)(1)(B).
May I Give or Accept Gifts or Entertainment to or From a Client?

An ethics ruling addresses the exchange of gifts and entertainment among covered members, the attest client, and certain persons associated with the client (for example, persons in key positions and persons owning 10 percent or more of the client’s outstanding equity securities or other ownership interests).

Independence is impaired if the firm, a member of the attest engagement team, or a person able to influence the engagement accepts a gift that is not clearly insignificant.

A covered member may give a gift to persons associated with the client and not impair independence if the gift is reasonable in the circumstances. In addition, covered members may give or receive entertainment, provided it was reasonable in the circumstances.

Another ethics ruling addresses the broader issue of integrity and objectivity when partners, professionals, or their firms exchange gifts or entertainment with clients or persons associated with clients. Generally, gifts are differentiated from entertainment by whether the client participates in the activity with the firm member (for example, giving tickets to a sporting event for the client to use would be considered a gift versus attending the event with the client, which would be considered entertainment).

Relevant factors in determining reasonableness include the event or occasion (if any) giving rise to the gift or entertainment, cost or value, frequency, whether business was conducted, and who participated.

Business Relationships

Which Business Relationships With a Client Impair Independence?

As a partner or professional employee of your firm, independence would be considered to be impaired if you entered into certain business relationships with an attest client of the firm. Accordingly, you may not serve a client as any of the following:

- Employee, director, officer, or in any management capacity
- Promoter, underwriter, or voting trustee
- Stock transfer or escrow agent
- General counsel (or equivalent)
- Trustee for a client’s pension or profit-sharing trust

In essence, any time you are able to make management decisions on behalf of a client or exercise authority over a client’s operations or business affairs, independence is impaired.

Your independence is considered impaired even if you were a volunteer board member because you would be part of the client’s governing body and, therefore, would be able to participate in the client’s management decisions.

This rule has two possible exceptions:

1. If you are an honorary director or trustee for a client that is a nonprofit charitable, civic, or religious organization, you may serve that client without impairing your independence if
   a. your position is purely honorary,
   b. you do not vote or participate in managing the organization, or
   c. your position is clearly identified as honorary in any internal and external correspondence.

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2. In addition, you also are permitted to serve on a client’s advisory board, provided all of the following criteria are met:
   a. The advisory board’s function is purely advisory.\textsuperscript{17}
   b. The advisory board does not appear to make decisions for the client.
   c. The advisory board and any decision-making boards are separate and distinct bodies.
   d. Common membership between the advisory board and any decision-making groups is minimal.

When evaluating your independence under this rule, you should examine the applicable board or committee charter to determine whether it is consistent with this ethics ruling.

The SEC prohibits direct or material indirect business relationships with a client (or persons associated with a client), except when the firm is acting as a consumer in the ordinary course of business (for example, purchasing goods or services from a client at normal commercial terms where these goods or services will be consumed by the firm). Examples of prohibited business relationships are joint business ventures, limited partnership agreements, and certain leasing interests.

Nonattest Services

Which Rules Describe the Nonattest Services That My Firm and I May or May Not Provide to Attest Clients?

The term \textit{nonattest services} includes accounting and consulting services that are not part of an attest engagement.\textsuperscript{18} The following nonattest services are specifically addressed in the rules:

- Bookkeeping services
- Nontax disbursement services
- Internal audit assistance
- Benefit plan administration
- Investment advisory or management services
- Tax compliance services
- Corporate finance consulting or advisory services
- Appraisal, valuation, or actuarial services
- Executive or employee search services
- Business risk consulting
- Information systems design, installation, or integration
- Forensic accounting services

\textsuperscript{17} When evaluating your independence under this rule, you should examine the applicable board or committee charter to determine whether it is consistent with this ethics ruling.

\textsuperscript{18} Defined in the AICPA Code of Professional Conduct, an attest engagement is one that requires independence under AICPA Professional Standards; for example, audits and reviews of financial statements or agreed-upon procedures performed under the attestation standards are considered attest engagements.
In addition to considering the general standard and four guiding principals, the SEC and PCAOB rules generally prohibit a CPA from providing the following services to an issuer contemporaneously with an audit:

- Bookkeeping and other services related to the client’s accounting records or financial statements
- Financial information systems design and implementation
- Appraisal or valuation services
- Actuarial services
- Internal audit outsourcing
- Management functions
- Human resources
- Broker-dealer, investment adviser, or investment banking
- Legal services
- Expert services unrelated to the audit
- Aggressive or confidential tax transactions (PCAOB)
- Personal tax services provided to persons in financial reporting oversight roles (PCAOB)

If your firm performs nonattest services for an attest client, the independence rules impose limits on the nature and scope of the services your firm may provide. In other words, the extent to which your firm may perform certain activities for the client will be limited by the rules. Further, certain services will be prohibited in total (for example, serving as a client’s general counsel). These rules apply during the period of the professional engagement and the period covered by the financial statements (to which the attest services relate). In November 2007, the AICPA staff issued frequently asked questions (FAQs) clarifying how the rules apply to nonattest services provided to a new attest client prior to the time the member was engaged to provide attest services.

In August 2007, the SEC staff updated its FAQ document entitled, Office of the Chief Accountant: Application of the Commissions Rules on Auditor Independence Frequently Asked Questions. FAQ 7 under “Prohibited and Non-audit Services” addressed the question of whether a successor auditor who performed one of the preceding services during the audit period (period covered by the financial statements) would be independent of the client. The FAQ states that if the services (a) relate solely to the prior period audited by the predecessor auditor and (b) were performed before the successor auditor was engaged to audit the current audit period, independence would not be impaired.

This section does not discuss each of these services, but rather focuses on a few for purposes of illustration. To see the full context of the rules, see Ethics Interpretation No. 101-3, “Performance of Nonattest Services,” under Rule 101, Independence (AICPA, Professional Standards, vol. 2, ET sec. 101 par. .05), and SEC Rule 2-01(c)(4), “Non-audit services.” You also are encouraged to review the Nonattest Services FAQ developed by the Professional Ethics Division.
The AICPA rules require a member to comply with more restrictive independence provisions, if applicable, of certain regulators, such as state boards of accountancy, the SEC, GAO, and DOL.

SEC and PCAOB rules require independence of the client and various affiliated entities.¹⁹

**Note:** SEC rules also require a client’s audit committee (or equivalent) to preapprove all audit and nonaudit services provided by the firm to the audit client and the client’s consolidated entities. Proposals to provide tax or internal control-related services are subject to more extensive audit committee preapproval requirements under PCAOB Rule 3524, Audit Committee Pre-approval of Certain Tax Services (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”), and PCAOB Rule 3525, Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”), respectively.

The SEC approved new PCAOB Rule 3526, Communication with Audit Committees Concerning Independence (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”), which supersedes the PCAOB’s existing interim standard, ISB Standard No. 1, Independence Discussions with Audit Committees (AICPA, PCAOB Standards and Related Rules, PCAOB Standards, As Amended, “Independence Standards Board”), and its interpretations. Before accepting a new audit engagement and annually thereafter, the auditor must describe in writing to the audit committee all relationships between the auditor and the client (including affiliates of both) that could reasonably be thought to bear on independence, discuss these matters with the audit committee, and document the substance of that discussion (effective September 30, 2008).

**AICPA General Requirements**

**General Requirement 1**

The following is one of the key principles underlying the AICPA rules on nonattest services: You may not serve—or even appear to serve—as a member of a client’s management. For example, you may not

1. make operational or financial decisions for the client,
2. perform management functions for the client, or
3. report to the board of directors on behalf of management.

In addition, the following are examples of the types of activities that impair independence:

1. Authorizing or executing a transaction on behalf of a client
2. Preparing the client’s source documents (for example, purchase orders)
3. Having custody of a client’s assets
4. Establishing or maintaining internal controls, including monitoring ongoing activities

**General Requirement 2**

To help ensure compliance with General Requirement 1, the second requirement states that the client must agree to assume certain responsibilities related to the nonattest services engagement. So, prior to agreeing to perform any nonattest services for the client, the firm must obtain the client’s agreement to

1. make all management decisions and perform all management functions;
2. designate an individual who possesses suitable skill, knowledge, and experience, preferably within senior management, to oversee the services;

¹⁹ See Rule 2-01(f)(4) and (6).
3. evaluate the adequacy and results of the services performed; and
4. accept responsibility for the results of the services.

With regards to the preceding Item 2, the firm should be satisfied that the client’s designee sufficiently understands the services to be performed in order to oversee them. This does not mean that the individual must be able to perform or reperform the services, but he or she should be able to understand and agree to the nature, objectives, and scope of the services; make all significant judgments; evaluate the adequacy and results of the service; accept responsibility for the service results; and ensure that the resulting work product meets the agreed-upon specifications. The client also must be willing to commit the time and resources needed for the designee to fulfill these duties.

**General Requirement 3**

Before performing nonattest services, the firm should establish and document its understanding with the client regarding the following:

1. Objectives of the engagement
2. Services to be performed
3. Client’s acceptance of its responsibilities
4. Member’s responsibilities
5. Any limitations of the engagement

The firm should document the understanding in the engagement letter, audit planning memo, or other internal firm file.

*Note:* Routine activities (for example, assisting clients with technical accounting questions, advising on internal controls, or providing periodic training on new pronouncements) that are part of the normal auditor-client relationship are exempt from the second and third general requirements.

**What Are the Rules Concerning Performing Bookkeeping Services for a Client?**

The AICPA independence rules prohibit members from acting as client management in all circumstances. Accordingly, a member may provide bookkeeping services if the client oversees the services and, among other things, performs all management functions and makes all management decisions in connection with the services. For example, if a member is engaged to provide bookkeeping services that will result in a set of financial statements, the client must

- approve all account classifications,
- provide source documents to the member so that the member can prepare journal entries, and
- take responsibility for the results of the member’s services (for example, financial statements).

*Note:* Proposing adjusting entries to a client’s financial statements as a part of the member’s audit, review, or compilation services is a normal part of those engagements and would not be considered the performance of a nonattest service subject to the general provisions of Ethics Interpretation No. 101-3, provided the client reviews these entries, understands the impact on its financial statements, and records any adjustments identified by the member.
Because of self-audit concerns, performing any type of bookkeeping service for a client (or affiliate of a client) is considered to impair independence under SEC rules, unless it is reasonable to expect that the results of the auditor’s services will not be subject to the firm’s audit procedures. The SEC considers there to be a rebuttable presumption that the results of these services would be subject to audit procedures and, therefore, the firm must overcome the presumption to perform the service.

This presumption of self-audit also applies to the following:

- Financial information design and implementation
- Appraisals, valuations, fairness opinions, or contribution-in-kind reports
- Actuarial-related advisory services
- Internal audit outsourcing

**May My Firm Provide Internal Audit Assistance to a Client?**

To perform internal audit assistance for a client and maintain independence, your firm may not act—or appear to act—as a member of the client’s management. For example, you and your firm may not

- make decisions on the client’s behalf, or
- report to the client’s governing body.

To maintain independence, the client must

- designate an individual or individuals who possess suitable skill, knowledge, and experience to oversee the internal audit function;
- determine the scope, risk, and frequency of internal audit activities;
- evaluate the findings and results of internal audit activities; and
- evaluate the adequacy of the audit procedures performed and related findings.


**May My Firm Provide Valuation, Appraisal, or Actuarial Services to a Client?**

Your firm may not provide valuation, appraisal, or actuarial services for a client if

- the results of the service would be material to the client’s financial statements, and
- the service involves a significant amount of subjectivity.

For instance, your firm may not perform a valuation in connection with a business combination that would have a material effect on a client’s financial statements because that service involves significant subjectivity (for example, setting the assumptions and selecting and applying the valuation methodology).

This rule has two limited exceptions. Valuation, appraisal, or actuarial services performed for nonfinancial statement purposes may be provided if they otherwise meet the rule’s general requirements (for example, the client assigns an individual to oversee the service who is in a position to make an informed judgment on and accept responsibility for the results of the service). Also, your firm may provide an actuarial valuation service.
of a client’s pension or postretirement liabilities because the results of the valuation would be reasonably consistent regardless of who performs the valuation.

The SEC prohibits your firm from providing valuation, appraisal, or any service involving a fairness opinion or contribution-in-kind report20 to clients unless it is reasonable to expect that your firm would not audit the results of those services.

In August 2008, the staff of the Professional Ethics Division issued nonauthoritative guidance (in the form of an FAQ) on the question of whether, under Ethics Interpretation No. 101-3, members could assist an attest client in applying Financial Accounting Standards Board (FASB) Statement No. 141 (revised 2007), Business Combinations, or FASB Statement No. 142, Goodwill and Other Intangible Assets, while maintaining independence. Specifically, the FAQ addresses whether the following services would be considered to impair independence:

- Providing the client advice on valuation methodologies and assumptions needed to perform the valuation
- Providing advice on valuation templates, software or other tools that allow the client to determine an appropriate value for acquired assets, goodwill, contingent consideration, and so on

May My Firm Provide Investment Advisory Services to a Client?

Here are examples of what you and your firm may do under the AICPA rules:

- Make recommendations to a client about the allocation of funds to various asset classes
- Analyze investment performance

However, the AICPA rules also indicate that you and your firm may not

- make investment decisions for the client,
- execute investment transactions, or
- take custody of a client’s assets.

May My Firm Design or Implement an Information System for a Client?

Your firm may not design or develop a client’s financial information system or make more than insignificant modifications to the source code underlying such a system. In addition, operating a client’s local area network is prohibited.

Your firm may install an accounting software package for a client, including helping the client set up a chart of accounts and financial statement format. Your firm also may provide training to the client’s employees on how to use an information system. Your firm may not, however, supervise the client’s employees in their day-to-day use of the system because that activity is a management function.

Your firm is not precluded from designing, implementing, integrating, or installing an information system that is unrelated to the client’s financial reporting process.21

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20 Per the SEC, fairness opinions and contribution-in-kind reports are opinions and reports in which your firm provides its opinion on the adequacy of consideration in a transaction.

21 Frequently Asked Questions (FAQ) to assist members in understanding and implementing the new information technology services provisions may be obtained at www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/Resources+and+Tools/Frequently+Asked+Questions.htm.
SEC rules prohibit your firm from providing any service related to a client’s financial information system design or implementation unless the results of your firm’s services would not be subject to audit procedures during an audit of the client’s financial statements. Your firm may either

- evaluate internal controls of a financial information system as it is being designed, implemented, or operated for the client by another service provider, or
- make recommendations on internal control matters to management in connection with a system design and implementation project being performed by another service provider.

Note: Effective for audits of fiscal years ending on or after November 15, 2007, your firm must obtain preapproval for these and other internal control-related services in accordance with PCAOB Rule 3525.

Fee Issues

What Types of Fee Arrangements Between My Firm and a Client Are Prohibited?

Two types of fee arrangements, contingent fees and commissions, are prohibited if the arrangement involves certain attest clients, even though the fee is not related to an attest service.

A contingent fee is an arrangement whereby (1) no fee is charged unless a specified result is attained or (2) the amount of the fee depends on the results of your firm’s services. Some examples of contingent fees are the following:

- Your firm receives a finder’s fee for helping a client locate a buyer for one of the client’s assets.
- Your firm performs a consulting engagement to decrease a client’s operating costs. The fee is based on a percentage of the cost reduction that the client achieves as a result of your service.

The following are exceptions:

- Fees fixed by a court or other public authority
- In tax matters, fees based on the results of judicial proceedings or the findings of governmental agencies

A commission is any compensation paid to you or your firm for (1) recommending or referring a third party’s product or service to a client or (2) recommending or referring a client’s product or service to a third party.

Examples of commissions are if you or your firm

- refers a client to a financial planning firm that pays you a commission for the referral,
- sells accounting software to a client and receives a percentage of the sales price (a commission) from a software company, or
- refers a nonclient to an insurance company client, which pays you a percentage of any premiums subsequently received (a commission) from the nonclient.

Commissions or contingent fee arrangements with a client are not allowed if your firm also provides one of the following services to a client:

- An audit of financial statements
- A review of financial statements
- A compilation of financial statements if a third party (for example, a bank or investor) will rely on the financial statements and the report does not disclose a lack of independence
- An examination of prospective financial statements
You may have commission and contingent fee arrangements with persons associated with a client—such as officers, directors, and principal shareholders—or with a benefit plan that is sponsored by a client (that is, the plan itself is not an attest client). For example, you may receive a commission from a nonclient insurer if you refer an officer of an attest client to the insurer and the officer purchases a policy. Even though this situation is permitted, you are still required to tell the officer that you received a commission for making the referral.

Note: State boards of accountancy and state societies also may have more restrictive regulations regarding fee arrangements, as well as specific disclosure requirements.

When Are Referral Fees Permitted?
The AICPA rule provides an exception for referral fees for recommending or referring a CPA’s services to another person or entity. That is, you may (1) receive a fee for referring a CPA’s services to any person or entity or (2) if you are a CPA, you may pay a fee to obtain a client. You must inform the client if you receive or pay a referral fee.

Is Independence Affected When a Client Owes the Firm Fees for Professional Services the Firm Has Already Provided?
If a client owes your firm fees for services rendered more than one year ago, your firm’s independence is considered impaired. It does not matter if the fees are related to attest services; what matters is that the client has an outstanding debt with the firm. This is the case even if the client has given you a note receivable for these fees.

The SEC generally expects payment of past-due fees before an engagement has begun, although a short-term payment plan may be accepted if the client has committed to pay the balance in full before the current year report is issued.22

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22 The exception generally has been applied only to engagements to audit a clients financial statements included in its annual report, not in a registration statement.
Does Being Compensated for Selling Certain Services to Clients Affect My Independence?

The AICPA rules do not specifically address this issue.

The SEC prohibits audit partners from being directly compensated for selling nonattest services to audit clients. The SEC believes that such financial incentives could threaten an audit partner’s objectivity and that the appearance of independence could be affected by such compensation arrangements. The rule does not prevent an audit partner from sharing in profits of the audit practice or the overall firm. Nor does it preclude the firm from evaluating a partner based on factors related to the sale of nonaudit services to clients (for example, the complexity of engagements or overall management of audit or nonaudit engagements).

Does It Matter If a Significant Proportion of My Firm’s Fees Come From a Particular Client?

The conceptual framework states that a financial self-interest threat may exist due to “excessive reliance on revenue from a single attest client.” In addition, Ethics Rule 102 and ET section 55, Article IV—Objectivity and Independence (AICPA, Professional Standards, vol. 2), discuss in broad terms that members should be alert for relationships that could diminish their objectivity and independence in performing attest services. The significance of a client to a member (or his or her firm)—measured in terms of fees, status, or other factors—may diminish a member’s ability to be objective and maintain independence when performing attest services.

To address this issue, firms should consider implementing the following policies and procedures to identify and monitor significant clients to help mitigate possible threats to a member’s objectivity and independence:

1. Policies and procedures for identifying and monitoring significant client relationships include
   a. considering client significance in the planning stage of the engagement.
   b. basing the consideration of client significance on firm-specific criteria or factors that are applied on a facts-and-circumstances basis (see the following section entitled “Factors to Consider in Identifying Significant Clients”).
   c. periodically monitoring the relationship. What constitutes periodic is a matter of judgment, but assessments of client significance that are performed at least annually can be effective in monitoring the relationship. During the course of such a review, a client previously deemed to be significant may cease to be significant. Likewise, clients not identified as significant could become significant whenever factors the firm considers relevant for identifying significant clients arise (for example, additional services are contemplated).

2. Policies and procedures to help mitigate possible threats to independence and objectivity by
   a. assigning a second (or concurring) review partner who is not otherwise associated with the engagement and practices in an office other than those that perform the attest engagement,
   b. subjecting the assignment of engagement personnel to approval by another partner or manager,
   c. periodically rotating engagement partners,
   d. subjecting significant client attest engagements to internal firm monitoring procedures, and
   e. subjecting significant client attest engagements to preissuance or postissuance reviews or the firm’s external peer review process.

23 Accounting firms with 10 or fewer partners and 5 or fewer audit clients that are issuers, as defined by the SEC, are exempt from this rule.
The most effective safeguards a firm can employ will vary significantly depending on the size of the firm, the way the firm is structured (for example, whether highly centralized or departmentalized), and other factors. For example, smaller firms (particularly those with one office) tend to be simpler and less departmentalized than larger firms. Generally, their processes will be less formal and involve fewer people than those of larger firms. Further, their managing partners may engage in frequent and direct communications with the firm’s partners and professional staff on client matters and be personally involved in staff assignments. Larger firms draw from a sizeable and diverse talent pool. In those firms, partners who are not affiliated with the engagement (or the client service office or business unit) can choose second (or concurring) review partners from outside the office performing the attest engagement. Midsized—or regional—firms may have aspects of both their smaller and larger counterparts, such as combining the ability to choose second-review partners from an office other than the client service office, while maintaining a relatively close connection to specific client relationships.

**Factors to Consider in Identifying Significant Clients**

Both qualitative and quantitative factors can reveal a significant client, including the following:

- The size of the client in terms of the percentage of fees or the dollar amount of fees versus total revenue of the engagement partner, office, or practice unit of the firm.
- The significance of the client to the engagement partner, office, or practice unit of the firm in light of the following:
  - Amount of time the partner, office, or practice unit devotes to the engagement
  - Effect on the partner’s stature within the firm due to his or her relationships with the client
  - Manner in which the partner, office, or practice unit is compensated
  - Effect that losing the client would have on the partner, office, or practice unit
- The importance of the client to the firm’s growth strategies (for example, the firm is trying to gain entry into a particular industry)
- The stature of the client, which may enhance the firm’s stature (for example, the firm is trying to gain entry into a particular industry)
- Whether the firm also provides services to related parties (for example, also provides professional services to affiliates or owners of the client)
- Whether the engagement is recurring or not

Judgment is necessary to determine whether a client is significant to the firm, office, practice unit, or partner of the firm. Firms will vary considerably in terms of the degree to which they consider some factors to be more pertinent than others. Gauges that relate to each relevant level within a firm (for example, firm, geographic region, office, or practice unit) may be useful but likely will be different for various levels within the firm.

According to SEC guidance, in general, if a firm derives more than 15 percent of its total revenues from one client or group of related clients, independence may be impaired because this may cause the firm to be overly dependent on the client or group of related clients.

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24 Assessing client significance at the business or practice unit level may be a more meaningful measure for firms that structure their practices along industry lines (such as healthcare or financial services).
Further Assistance

Where Can I Find Further Assistance With My Independence Questions?

The AICPA Plain English Guide to Independence does not address many subjects included in the AICPA rules. Readers are encouraged to view the online version of the Code at www.aicpa.org/about/code/index.html.

In addition, readers should refer to ET section 100.01 in evaluating whether a specific circumstance that is not addressed in the Code would pose an unacceptable threat to independence.

As specific services and situations arise in practice, refer to the independence literature and consult with those responsible for independence in your firm. If you need further assistance researching your question, contact one of the following organizations for guidance.

The AICPA has a variety of resources for practitioners:

- The Web site address for information about the AICPA’s ethics standard-setting activities is www.aicpa.org/Professional+Resources/Professional+Ethics/Code+of+Professional+Conduct/Professional+Ethics/Exposure+Drafts+-+Standard+Setting/.
- For resources related to understanding and applying nonattest services rules, see www.aicpa.org/Professional+Resources/Professional+Ethics/Code+of+Professional+Conduct/Professional+Ethics/Resources+and+Tools/.
- For the Background and Basis for Conclusions document for nonattest services, see www.aicpa.org/download/ethics/Basis_for_Conclusions_Non_Attest_Services.pdf.
- For independence inquiries by phone, call (888) 777-7077. Send e-mail inquiries to ethics@aicpa.org.
- The AICPA interactive CD-ROM course on independence, titled Independence, teaches the AICPA and SEC independence rules and qualifies for eight hours of Continuing Professional Education credits. See www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/Ethics/PRDOVR~PC-739155HS/PC-739155HS.jsp.

SEC resources are as follows:

- Information for accountants, including independence, may be found at Office of the Chief Accountant of the United States at www.sec.gov/about/offices/oca/ocaprof.htm.
- U.S. Securities and Exchange Commission, Office of the Chief Accountant, 100 F Street, NE, Washington, DC 20549; (202) 551-5300 (Phone); (202) 772-9252 (Fax).

The PCAOB has a Web site at www.pcaobus.org. Standards and rules can be found at www.pcaobus.org/Standards/index.aspx.

GAO resources are as follows:

- Obtain the GAO Yellow Book requirements at GAO: Especially for the Auditing and Accountability Community
- Yellow Book Independence Standard (www.gao.gov/govaud/govaudhtml/d07731g-5.html#pgfld-1034319)
- Obtain answers to FAQs on independence (www.gao.gov/govaud/d02870g.pdf)
- Slide presentation on independence standard (www.gao.gov/govaud/july2007slides.pdf)
- Direct inquiries to Michael Hrapsky, Senior Project Manager—Government Auditing Standards at (202) 512-9535 or e-mail yellowbook@gao.gov

DOL resources are as follows:
- DOL Regulation 2509.75-9, Interpretive bulletin relating to guidelines on independence of accountant retained by Employee Benefit Plan. This regulation can be found at www.dol.gov/dol/allcfr/EBSA/Title_29/Part_2509/29CFR2509.75-9.htm.
- Direct inquiries to the DOL at 1-866 4-USA-DOL.

Banking regulators’ resources are as follows

International Federation of Accountants (IFAC) resources are as follows:
- Information about the International Ethics Standards Board for Accountants (IESBA) can be found on the IFAC’s Web site, www.ifac.org, at www.ifac.org/Ethics/.
- The IESBA’s Code of Ethics for Professional Accountants can be found at www.ifac.org/Members/Pubs-Details.tmpl?PubID=1045607042914590&Category=Ethics.

[The next page is 9000-91.]
AAM Section 8260

SEC and PCAOB Developments—2008

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert provides auditors and accountants practicing in business and industry with a detailed overview of recent developments at the Securities and Exchange Commission and Public Company Accounting Oversight Board with respect to financial reporting and auditing matters.

This document has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Securities and Exchange Commission Developments

.01 The summaries that follow are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable rule or development. In addition, the information presented in the following does not encompass all of the recent issuances and activities of the U.S. Securities and Exchange Commission (SEC). See the SEC Web site at www.sec.gov for complete information.

SEC Final Rules

Extension Granted Involving Internal Control Over Financial Reporting

.02 On June 26, 2008, the SEC released the final rule Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers, which amends a temporary rule. The final rule extends the time period that a nonaccelerated filer would be required to provide the auditor’s attestation report on internal control over financial reporting in an annual report filed for fiscal years ending on or after December 15, 2009. The temporary rule had originally set a requirement of December 15, 2008. This amendment therefore extends that requirement one year. The full text of this rule can be found at www.sec.gov/rules/final/2008/33-8934.pdf.

SEC Eases Acceptance of International Financial Reporting Standards Financial Statements

.03 On December 21, 2007, the SEC took a major step toward easing the acceptance of International Financial Reporting Standards (IFRS) financial statements by adopting rules to accept from foreign private issuers financial statements prepared in accordance with IFRS as issued by the International Accounting Standards Board (IASB) without reconciliation to U.S. GAAP. This rule marks an important step in the process toward the development of a single set of high quality, globally accepted accounting standards. This rule became effective March 4, 2008. Readers can access this rule at www.sec.gov/rules/final/2007/33-8879.pdf.

.04 More than 100 countries now either require or allow the use of IFRS for the preparation of financial statements by listed companies, and additional countries are moving to do the same. This recent movement to IFRS outside the United States has resulted in an increase of filings with the SEC of foreign private issuers.
that represent in the footnotes to their financial statements that their financial statements comply with IFRS as published by the IASB—from a relative few in 2005 to approximately 110 in 2006. The SEC expects this number will continue to increase in the future, particularly pursuant to Canada’s announced move to IFRS, as there currently are approximately 500 foreign private issuers from Canada.

.05 This movement to IFRS also has begun to affect U.S. issuers, in particular those with a significant global footprint. For instance, certain U.S. issuers may compete for capital globally in industry sectors in which a critical mass of non-U.S. companies report under IFRS. Also, U.S. issuers with subsidiaries located in jurisdictions that have moved to IFRS may prepare those subsidiaries’ financial statements in IFRS for purposes of local regulatory or statutory filings. Readers should remain alert to developments regarding convergence.

Smaller Reporting Company Regulatory Relief and Simplification

.06 On December 19, 2007, the SEC adopted amendments to its disclosure and reporting requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934 to expand the number of companies that qualify for its scaled disclosure requirements for smaller reporting companies. Companies that have less than $75 million in public equity float will qualify for the scaled disclosure requirements under the amendments. Companies without a calculable public equity float will qualify if their revenues were under $50 million in the previous year. To streamline and simplify regulation, the amendments move the scaled disclosure requirements from Regulation S-B into Regulation S-K of the Securities Act of 1933. The rule became effective February 4, 2008, except for Title 17 U.S. Code of Federal Regulations (CFR) Part 249.308b Form 10-QSB, which will be removed effective October 31, 2008, and 17 CFR 228 and 249.310b Form 10-KSB, which will both be removed effective March 15, 2009. The full text of this rule as well as detailed compliance information and dates can be found at www.sec.gov/rules/final/2007/33-8876.pdf.

Electronic Filing and Revision of Form D

.07 On February 6, 2008, the SEC adopted rule amendments mandating the electronic filing, via the Internet, of information required by the Securities Act of 1933 Form D. The SEC also adopted revisions to Form D and to Regulation D in connection with the electronic filing requirement. The revisions simplify and restructure Form D and update and revise its information requirements. The information required by Form D will be filed with the SEC electronically through a new online filing system that will be accessible from any computer with Internet access. The data filed will be available on the SEC Web site and will be interactive and searchable. This rule is effective September 15, 2008, except for amendments to 17 CFR 232.101(c)(6) and 232.201(a) that are effective March 28, 2008, 17 CFR 232.101(a)(1)(xiii) that is effective March 16, 2009, and 17 CFR 230.503T, 232.101(b)(10), and 239.500T that are effective from September 15, 2008 to March 16, 2009. The full text of this rule can be found at www.sec.gov/rules/final/2008/33-8891.pdf.

.08 This rule is another step toward streamlining the filing process with the SEC and moving toward eXtensible Business Reporting Language (XBRL) filing. The Center for Audit Quality (CAQ), which is affiliated with the AICPA, commented on this rule and recommended that all Form D information be filed in the standard XBRL format. The full text of the comment letter can be found at www.thecaq.org/members/pdfs/CAQ_Letter%201_071307.pdf. In addition, there is a separate section of this alert, “Interactive Data and XBRL Initiatives,” that provides further information on XBRL.

SEC Interpretive Releases

.09 On August 1, 2008, the SEC issued an interpretive release that provides guidance on the use of company Web sites under the Securities Exchange Act of 1934 and the antifraud provisions of federal securities laws. The SEC is soliciting comments on issues relating to the use of company technology to provide information to investors. The full text of the release can be found at www.sec.gov/rules/interp/2008/34-58288.pdf.

1 The 2008 version of Title 17, Commodity and Securities Exchanges, of U.S. Code of Federal Regulations can be found at www.access.gpo.gov/cgi-bin/cfrassemble.cgi?title=200817.
SEC No-Action and Exemptive Orders

.10 To respond to an inquiry from a public company, the SEC issues Securities Exchange Act of 1934 no-action and exemptive orders, as needed. Exemptive orders are similar to no-action letters because they grant permission from the SEC to move forward on a new initiative. Exemptive orders are issued by or on behalf of the SEC and may exempt a certain type of transaction or situation from designated provisions of the securities laws. No-action letters are issued by SEC staff and indicate whether the staff would recommend that the SEC pursue an enforcement action if the person or entity requesting the letter takes, or omits to take, certain actions. Recently issued no-action and exemptive orders can be found at www.sec.gov/interps/noaction.shtml.

SEC Proposed Rules

Modernization of the Oil and Gas Reporting Requirements

.11 On June 26, 2008, the SEC proposed revisions to its oil and gas reporting requirements, which currently exist under Regulations S-K and S-X, as well as Securities Act Industry Guide 2, “Disclosure of Oil and Gas Operations.” The revisions are intended to provide investors with a more meaningful and comprehensive understanding of oil and gas reserves, which should help investors evaluate the relative value of oil and gas companies. The SEC adopted the current reporting requirements for oil and gas reserves between 1978 and 1982, and since then, there have been significant changes in the oil and gas industry. The proposed amendments are designed to modernize and update the oil and gas disclosure requirements to align them with current practices and changes in technology. The SEC is also proposing to codify Industry Guide 2 in Regulation S-K, with several additions to, and deletions of, current industry guide items. These changes would further harmonize oil and gas disclosures by foreign private issuers with the proposed disclosures for domestic issuers. The full text of the proposal can be found at www.sec.gov/rules/proposed/2008/33-8935.pdf.

Interactive Data to Improve Financial Reporting

.12 On May 30, 2008, the SEC proposed amendments to require companies to provide their financial statements to the SEC in interactive data format using XBRL with a proposed three year phase-in schedule. The proposed rules would apply to both domestic and foreign companies using U.S. GAAP and eventually to foreign private issuers using IFRS. The full text of this proposal can be found at www.sec.gov/rules/proposed/2008/33-8924.pdf.

.13 In addition, on June 10, 2008, the SEC released proposed rules requiring mutual funds to provide risk-return summary information in a format that would improve its usefulness to investors. Mutual funds would be required to provide the risk-return summary section of their prospectuses to the SEC using XBRL. The interactive data would be provided as an exhibit to registration statements. The SEC is also proposing to permit investment companies to submit portfolio holdings information in the SEC’s interactive data voluntary program without being required to submit other financial information. The full text of the proposal can be found at www.sec.gov/rules/proposed/2008/33-8929.pdf.

Foreign Issuer Reporting Enhancements

.14 On February 29, 2008, the SEC proposed a number of changes to its rules relating to foreign private issuers that are intended to improve the accessibility of the U.S. public capital markets to these issuers, as well as to enhance the information that is available to investors. The SEC has proposed amendments that would enable foreign issuers to test their qualification to use the forms and rules available to foreign private issuers once a year, rather than continuously. The SEC also proposed amendments to change the deadline for annual reports filed by foreign private issuers and to eliminate an option under which foreign private issuers are permitted to omit segment data from their U.S. GAAP financial statements. The SEC is also proposing an amendment to the rule pertaining to going-private transactions to reflect the new termination of reporting and deregistration rules for foreign private issuers. In addition, the SEC is soliciting comments...
on proposals that would revise the annual report and registration statement forms used by foreign private issuers to improve certain disclosures provided in these forms. The full text of the proposal can be found at www.sec.gov/rules/proposed/2008/33-8900.pdf.

**SEC Staff Accounting Bulletins**

SEC Staff Accounting Bulletins (SABs) reflect SEC staff views regarding accounting-related disclosure practices. They represent interpretations and policies followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of federal securities laws. There have been two new SABs published since the publication of the previous edition of this alert, as discussed in the following sections.

**SAB No. 110, Topic 14, Share-Based Payment, Staff Views Regarding the “Simplified” Method, as Discussed in SAB No. 107, Topic 14**

On December 21, 2007, the SEC released SAB No. 110. This SAB expresses the views of the staff regarding the use of a “simplified” method, as discussed in SAB No. 107, in developing an estimate of the expected term of “plain vanilla” share options in accordance with Financial Accounting Standards Board (FASB) Statement No. 123 (revised 2004), *Share-Based Payment*. In particular, the staff indicated in SAB No. 107 that it will accept a company’s election to use the simplified method, regardless of whether the company has sufficient information to make more refined estimates of expected term. At the time SAB No. 107 was issued, the staff believed that more detailed external information about employee exercise behavior (for example, employee exercise patterns by industry or other categories of companies) would, over time, become readily available to companies. Therefore, the staff stated in SAB No. 107 that it would not expect a company to use the simplified method for share option grants after December 31, 2007. The staff understands that such detailed information about employee exercise behavior may not be widely available by December 31, 2007. Accordingly, the staff will continue to accept, under certain circumstances, the use of the simplified method beyond December 31, 2007. The full text can be found at www.sec.gov/interp/account/sab110.htm.

**SAB No. 109, Topic 5, Miscellaneous Accounting, Staff Views on Written Loan Commitments That Are Accounted For at Fair Value Through Earnings Under GAAP**

On November 5, 2007, the SEC released SAB No. 109. This SAB expresses the views of the staff regarding written loan commitments that are accounted for at fair value through earnings under GAAP. SAB No. 105, *Application of Accounting Principles to Loan Commitments*, provided the views of the staff regarding derivative loan commitments that are accounted for at fair value through earnings pursuant to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. SAB No. 105 stated that in measuring the fair value of a derivative loan commitment, the staff believed it would be inappropriate to incorporate the expected net future cash flows related to the associated servicing of the loan. This SAB supersedes SAB No. 105 and expresses the current view of the staff that, consistent with the guidance in FASB Statement No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*, and FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, the expected net future cash flows related to the associated servicing of the loan should be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. SAB No. 105 also indicated that the staff believed that internally developed intangible assets (such as customer relationship intangible assets) should not be recorded as part of the fair value of a derivative loan commitment. This SAB retains that staff view and broadens its application to all written loan commitments that are accounted for at fair value through earnings.

The staff expects registrants to apply the views in question 1 of SAB No. 109 on a prospective basis to derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The full text of this SAB can be found at www.sec.gov/interp/account/sab109.htm.
SEC Office of the Chief Accountant: Staff Letters to Industry

Readers should be aware of the following staff letters to industry that provide helpful guidance and clarification regarding the SEC staff’s interpretation of certain accounting issues and their application under U.S. GAAP.

Letter From SEC Chief Accountant Concerning the American Securitization Forum’s Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans

This letter, sent January 8, 2008 to Arnold Hanish, chairman of the Committee on Corporate Reporting, and Sam Ranzilla, chairman of the Professional Practice Executive Committee for the AICPA’s Center for Audit Quality, addresses whether modifications of Segment 2 subprime adjustable rate mortgage loans that occur pursuant to the American Securitization Forum framework would result in a change in the status of a transferee as a qualifying special-purpose-entity under paragraph 55 of FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extin guishments of Liabilities—a replacement of FASB Statement No. 125. The full text of the letter can be found at www.sec.gov/info/accountants/staffletters/hanish010808.pdf.

Letter From SEC Chief Accountant Concerning the Use of Employee Stock Appreciation Rights Securities to Value Employee Share-Based Payment Awards Under FASB Statement No. 123R

This letter, sent October 17, 2007 to Zions Bancorporation, provides guidance concerning if the price obtained for employee stock appreciation rights securities from Zions’s auction could be used as an estimate of fair value, in accordance with FASB Statement No. 123(R). The full text of the letter can be accessed at www.sec.gov/info/accountants/staffletters/zions101707.pdf.

Recent Guidance Provided by the SEC’s Division of Corporation Finance

Accounting Guidance to Certain Registrants in the Form of Sample Letters

In February 2005, the staff of the Division of Corporation Finance publicly posted sample letters sent to certain registrants to promote widespread awareness of certain accounting issues and to provide examples of comments that other registrants should consider as they prepare future SEC filings, as applicable. Since the last edition of this alert, the following two letters that have been posted.

Sample Letter to Public Companies on Management Discussion and Analysis Disclosure Regarding the Application of FASB Statement No. 157, Fair Value Measurements

In March 2008, the Division of Corporation Finance sent an illustrative letter to certain public companies identifying a number of fair value disclosure issues they may wish to consider in preparing the Management’s Discussion and Analysis (MD&A) sections of their upcoming quarterly reports on Form 10-Q. The sample letter can be found at www.sec.gov/divisions/corpfin/guidance/fairvaluelt0308.htm.

Sample Letter Sent to Public Companies That Have Identified Investments in Structured Investment Vehicles, Conduits, or Collateralized Debt Obligations

In December 2007, the Division of Corporation Finance sent an illustrative letter to certain public companies identifying a number of off-balance sheet disclosure issues they may wish to consider in preparing the MD&A sections of their upcoming annual reports on Form 10-K or Form 20-F. The sample letter can be accessed at www.sec.gov/divisions/corpfin/guidance/cfoffbalanceltr1207.htm.
Additional Comments and Guidance From the Staff of the Division of Corporation Finance

Staff Comments on Annual Reports Containing Financial Statements Prepared For the First Time on the Basis of IFRS

.25 In 2006, the SEC staff reviewed the annual reports of more than 100 foreign private issuers containing financial statements prepared for the first time on the basis of IFRS. The staff comments include the following topics:

- Assertion of compliance with IFRS
- Manner of presentation
- Topical areas, including revenue recognition, intangible assets and goodwill, impairment of long-lived assets, leases, contingent liabilities, and financial instruments

.26 The SEC staff also recently posted the company responses to their comments, which can be found at www.sec.gov/divisions/corpfin/ifrs_reviews.htm.

SEC Smaller Company Reporting Initiatives

.27 As discussed in the “SEC Final Rules” section of this alert, the SEC released a final rule that extends the time period that a nonaccelerated filer would be required to provide the auditor’s attestation report on internal control over financial reporting. Since introduction of the requirement for management and auditor attest reports on internal control over financial reporting, the SEC has focused on providing guidance to small businesses and related issues. Some of the more recent initiatives are highlighted in the following.

Sarbanes-Oxley Section 404, A Guide for Small Business

.28 On December 4, 2007, the SEC issued the brochure Sarbanes-Oxley Section 404—A Guide for Small Businesses in preparation for the upcoming effective date of Section 404 of the Sarbanes-Oxley Act of 2002 for smaller public companies’ management assessment of internal control over financial reporting. The brochure is intended to assist smaller companies with their first time assessment under Section 404 of Sarbanes-Oxley by outlining applicable guidance and providing tips for performing management’s assessment. The brochure outlines three key steps for small businesses in beginning this evaluation, including the following:

- Identifying financial reporting risks and controls that address those risks
- Assessing whether internal controls work in practice
- Reporting conclusions on overall effectiveness and deficiencies

.29 There is also guidance included on what types of records small businesses need to keep to ensure they are in compliance with the SEC rules. The brochure can be found at www.sec.gov/info/smallbus/404guide.shtml.

Small Reporting Company Compliance and Disclosure Interpretations

.30 Since the adoption of the SEC’s smaller reporting company rules in Release No. 33-8876, Smaller Reporting Company Regulatory Relief and Simplification, on December 19, 2007 (as discussed in the “SEC Final Rules” section of this alert), the Division of Corporation Finance posted Smaller Reporting Company Compliance and Disclosure Interpretations. These interpretations address the following questions:

1. Do all current reporting companies have an opportunity to determine if they qualify for treatment as a smaller reporting company applying the $75 million public float test as of the end of the second quarter in the fiscal year next ending after December 15, 2007, or the alternative $50 million annual revenue test for companies that cannot calculate their public float?
2. Could a company with a fiscal year ended December 31, 2007 be both a smaller reporting company and an accelerated filer for 2008, if it was an accelerated filer with respect to filings due in 2007 and had a public float of $60 million on the last business day of its second fiscal quarter of 2007?

3. Will a company that does not qualify as a smaller reporting company this year be able to qualify as a smaller reporting company if its public float falls below $75 million at the end of its second fiscal quarter in a future fiscal year?

4. The version of the adopting release on smaller reporting company regulatory relief and simplification currently posted on the SEC’s Web site states the SEC added Item 407(g) to Regulation S-K to provide that smaller reporting companies are not “required to provide an Audit Committee [Financial Expert] Report until the first annual report after their initial registration statement is filed with the Commission and becomes effective.” An asterisked footnote indicates that the bracketed language was inadvertently omitted from the release when initially published. The initial version of the release indicated that smaller reporting companies were not required to provide an audit committee report under the circumstances described. Are smaller reporting companies required to provide an audit committee report?

5. Do the new disclosure requirements available to smaller reporting companies apply to the Schedule 14A disclosure requirements that refer registrants to specific paragraphs of items in Regulation S-K?

6. Is a smaller reporting company required to describe its policies and procedures for review, approval, or ratification of transactions with related persons as specified by Item 404(b) of Regulation S-K if a schedule or form being used for a filing requires the company to furnish the information required by Item 404(b)?

The full text of the questions and answers regarding smaller company reporting requirements can be found at www.sec.gov/info/smallbus/src-cdinterps.htm.

Changeover to the SEC’s Smaller Reporting Company System by Small Business Issuers and Non-Accelerated Filer Companies: A Small Entity Compliance Guide

On January 25, 2008, the SEC issued a compliance guide that, according to the guide’s introduction, “explains how current small business issuers and other smaller companies newly eligible to use the SEC’s scaled disclosure rules, primarily ‘non-accelerated filer’ companies, can make the changeover to the new rules with minimal effort and expense.” This guide is divided into the following sections:

- Qualifying as a “Smaller Reporting Company”
- Compliance Date Guidance for Current Small Business Issuers
- Transition to Non-SB Forms—Guidance for Current Small Business Issuers
- Guidance for Newly Eligible Smaller Reporting Companies
- Chart of Scaled Item Requirements in Regulation S-K for Smaller Reporting Companies

You can access the complete compliance guide at http://sec.gov/info/smallbus/secg/smrepcosysguid.pdf.

Nonaccelerated Filers, Small Business Issuers, and Smaller Reporting Companies

The SEC has issued several proposals and adopted final rules related to nonaccelerated filers, small business issuers, and smaller reporting companies in the past year. Because some practitioners may find this terminology confusing, this alert outlines the definitions of each and the recent changes to the Securities Exchange Act of 1934 due to the adoption of SEC Release No. 33-8876, which became effective February 4, 2008. In many situations, a company will have to determine whether it is an accelerated filer, nonaccelerated filer, or smaller reporting company. A company’s status as an accelerated or nonaccelerated filer may determine such issues as when the company must file its Form 10-K and Form 10-Q and when audit
Attestation reports under Section 404(b) of Sarbanes-Oxley are required to be filed. A company that qualifies as a smaller reporting company has the choice of using the standard disclosure requirements in Regulation S-K or the scaled disclosure requirements available to smaller reporting companies in Regulation S-K. Although the scaled disclosure requirements are similar to the standard disclosure requirements, there are some differences, including the number of years of financial statements to be provided and the new Article 8 of Regulation S-X for smaller reporting companies.

Nonaccelerated Filer

.35 Although the term nonaccelerated filer is not defined specifically in the SEC rules, the SEC uses the term to refer to a reporting company that does not meet the Securities Exchange Act of 1934 Rule 12b-2 (17 CFR 240.12b-2) definition of either an accelerated filer, large accelerated filer, or smaller reporting company.

Small Business Issuer

.36 Prior to the issuance of the SEC Release No. 33-8876, Rule 12b-2 defined a small business issuer as an entity that meets the following criteria:

- Revenues of less than $25 million
- U.S. or Canadian issuer
- Not an investment company and not an asset-backed issuer; and if a majority owned subsidiary, the parent corporation is also a small business issuer
- Public float of less than $25 million

.37 Currently, the small business issuer definition is being phased out and is expected to be completely removed by March 15, 2009.

Smaller Reporting Company

.38 The smaller reporting company amendments recently adopted by the SEC, which became effective February 4, 2008, were intended to give smaller companies faster and easier access to capital when they need it or when market conditions are favorable. Specifically, the former small business issuer and nonaccelerated filer categories, to the extent feasible, were combined to create a new category called smaller reporting company. Companies that have less than $75 million in public float will now qualify as smaller reporting companies. Companies without a calculable public equity float will qualify if their revenues were less than $50 million in the last fiscal year. The definition of smaller reporting company effectively expands the number of companies that qualify for the scaled disclosure requirements previously available to small business issuers. At the date of this writing, the Federal Register provides the following definition of the new term smaller reporting company:

- An issuer that is not an investment company, an asset-backed issuer, or a majority-owned subsidiary of a parent that is not a smaller reporting company
- An issuer with public float of less than $75 million as of the last business day of its most recently completed second fiscal quarter
- An issuer that, in the case of an initial registration statement, had a public float of less than $75 million as of a date within 30 days of the date of filing the registration statement
- An issuer that, in the case where it does not have any public float, has annual revenues of less than $50 million during the most recently completed fiscal year for which audited financial statements are available

2 See footnote 1 in paragraph .06.
.39 Although there is considerable overlap between the definitions of a smaller reporting company and a nonaccelerated filer, the terms are not synonymous. For example, a company that has publicly issued a class of debt securities, but does not have a class of equity securities outstanding would be a nonaccelerated filer even though it may not meet the definition of a smaller reporting company. Many companies that are debt-only issuers, however, are subsidiaries of larger public companies that meet the definition of accelerated filer or large accelerated filer. Therefore, the SEC did not think it was necessary to make a distinction between these two categories for purposes of their latest rule, Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers.

.40 It is also important to note that whether or not an issuer is a smaller reporting company is determined on an annual basis. It is therefore possible that a company’s status as a small reporting company could change from year to year. The SEC recently issued some questions and answers (Q&As) dealing with this particular issue, especially in light of current market conditions. These Q&As can be accessed at www.sec.gov/info/smallbus/src-cdinterps.htm. You can also access all of the definitions described in the preceding in the Federal Register.3

Government-Business Forum on Small Business Capital Formation

.41 The SEC hosts an annual forum that focuses on the capital formation concerns of small businesses. Called the SEC Government-Business Forum on Small Business Capital Formation, this gathering has assembled annually since 1982, as mandated by the Small Business Investment Incentive Act of 1980. A major purpose of the forum is to provide a platform for small businesses to highlight perceived unnecessary impediments to the capital-raising process. The SEC plans to host its 2008 Government-Business Forum on Small Business Capital Formation in the fall of 2008. Further information will be made available as plans are finalized, and can be found at www.sec.gov/info/smallbus/sbforum.shtml.

SEC Comment Letters

.42 The following are a list of common themes found in the latest SEC comment letters:

- Fair value—consideration of illiquidity in credit markets, as well as methodology and assumptions
- Hedge accounting—the shortcut method, as well as having adequate documentation at inception
- Impairments—methods and assumptions used, timing of the charge, and disclosures
- Contingencies—lack of disclosures
- Non-GAAP financial measures—a full income statement eliminating FASB Statement No. 123(R) effects
- Statement of cash flows—materiality and classification
- Business combinations—purchase price allocations
- Segment reporting—number of segments, as well as changes in segments
- Taxes—uncertain tax position disclosures, reasonable possible exposures within the next 12 months
- Purchase price allocations—identification of all intangible assets
- Earnings per share (EPS)—securities that could potentially dilute EPS
- MD&A—more transparent analysis needed
- Asset retirement obligations—details needed concerning why estimates could not be made
- Emerging Issues Task Force (EITF) Issue No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock”—lack of disclosure of terms and its affect on accounting

3 See footnote 1 in paragraph .06.
• Critical accounting estimates
• Revenue policy disclosures—footnotes not consistent with other parts of the filing
• Pro forma disclosures—forecasts should not be included in pro forma information

Updates and further explanation of current SEC comment letters are discussed in the AICPA’s SEC Quarterly Update Webcast Series. Information on all SEC webcasts can be found at www.sec.gov/news/webcasts.shtml. Further information on these webcasts can be found in the “Resource Central” section near the end of this alert.

Interactive Data and XBRL Initiative

XBRL is an extensible markup language (XML) used to communicate financial and business data electronically. XBRL is being developed by an international nonprofit consortium with more than 450 member organizations, including accounting firms, software providers, financial intermediaries, academics, and technologists.

XBRL is used to “tag” financial statements so that the information in those statements is machine readable, thereby allowing users to analyze financial information more easily and quickly. To assist with the tagging process, XBRL US has currently developed more than 11,000 financial concepts that essentially represent a dictionary of U.S. GAAP and other financial reporting requirements.

On January 11, 2008, the SEC Advisory Committee on Improvement to Financial Reporting proposed that the SEC adopt a mandatory phase-in of XBRL for a specified time period, starting with the largest 500 domestic public reporting companies. On May 30, 2008, the SEC proposed amendments to require companies to provide their financial statements to the SEC in interactive data format using XBRL with a proposed three year phase-in schedule. The proposed rules would apply to both domestic and foreign companies using U.S. GAAP and then eventually apply to foreign private issuers using IFRS. Be sure to check the SEC’s Interactive Data link at www.sec.gov to view the current status of the project.

SEC Advisory Committee on Improvements to Financial Reporting

In June 2007, the SEC established the Advisory Committee on Improvements to Financial Reporting. This committee held its first meeting on August 2, 2007. The SEC has appointed 17 members representing investors, companies, and other entities within the securities markets. Five other people serve as official observers of the advisory committee, representing FASB, the Public Company Accounting Oversight Board (PCAOB), the U.S. Department of Treasury, IASB, and federal banking regulators. The advisory committee is examining the U.S. financial reporting system and providing recommendations about how to improve its usefulness for investors and reduce the unnecessary complexities for U.S. companies. More specifically, the advisory committee is exploring ways to redesign the financial reporting system to take advantage of interactive data and XBRL for financial reporting.

The SEC’s charter identifies the following more specific areas of inquiry for the advisory committee:
• The current approach to setting financial accounting and reporting standards, including (a) the principles-based versus rules-based standards; (b) the inclusion within standards of exceptions, bright lines, and safe harbors; and (c) the process for providing timely guidance on implementation issues and emerging issues
• The current process of regulating compliance with accounting and reporting standards
• The current system for delivering financial information to investors and accessing that information
• Other environmental factors that drive unnecessary complexity, including the possibility of being second-guessed, the structuring of transactions to achieve an accounting result, and whether there is hesitation by professionals to exercise professional judgment in the absence of detailed rules
• Whether there are current accounting and reporting standards that do not result in useful information to investors or impose costs that outweigh the resulting benefits
• Whether the growing use of international accounting standards has an effect on the relevant issues relating to complexity of U.S. accounting and reporting standards and the usefulness of the U.S. financial reporting system

.49 The advisory committee has held five meetings so far in 2008 and issued a draft final report in July 2008. In chapter 1 of the draft report, the committee discussed its work in the area of substantive complexity; namely, its proposals related to industry-specific guidance, alternative accounting policies, and approaches regarding the use of bright lines and the mixed attribute model.

.50 The committee is also welcoming feedback on its work from investors, registrants, auditors, and others. Comments can be submitted and additional information can be found at the committee’s Web site: www.sec.gov/about/offices/oca/acifr.shtml.

The SEC’s IFRS “Roadmap”

.51 The SEC has outlined several initiatives concerning the possible use of IFRS in the United States in the spotlight section of its Web site. This section provides information on the following topics and groups:
• SEC roundtable on IFRS held on August 4, 2008
• SEC roundtable on practical issues surrounding the use of IFRS in the United States in recent years, and the potential expanded use of IFRS in future years
• SEC roundtable on IFRS in the U.S. markets held on December 13, 2007
• Proposed rulemaking and request for public comments
• SEC staff roundtable on IFRS roadmap
• SEC press releases
• Staff review of financial statements prepared in accordance with IFRS
• Speeches and public statements

.52 This information can be accessed at www.sec.gov/spotlight/ifrsroadmap.htm.

PCAOB Developments

.53 The summaries that follow are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable rule or development. In addition, the information presented in this section does not encompass all of the recent issuances and activities of the PCAOB. See the PCAOB Web site at www.pcaob.org for complete information.

PCAOB Approved Rules and Standards

Rules for Succeeding to Registration Status of Predecessor Firm

.54 On July 29, 2008, the PCAOB adopted rules and a corresponding form that govern when a firm would be allowed to succeed to the registration status of a predecessor firm following a merger or other change in the registered firm’s legal form.

.55 Under Section 102(a) of Sarbanes-Oxley and PCAOB rules, a public accounting firm must be registered with the PCAOB in order to prepare or issue audit reports for public companies or to play a substantial role in the preparation or furnishing of such audit reports. To become registered, a public accounting firm files an application for registration on PCAOB Form 1, which the PCAOB may approve or
disapprove. The rules and form (PCAOB Form 4) adopted in July identify the circumstances in which the registration status of a registered firm may continue in effect even after the firm’s legal form has changed or the firm has combined with another firm, without the new legal entity needing to apply for registration on Form 1. The PCAOB release, along with the text of the rules and the instructions to Form 4, can be found at www.pcaob.org/Rules/Docket_020/index.aspx.

**PCAOB Auditing Standard No. 6, Evaluating Consistency of Financial Statements**

.56 In January 2008, the PCAOB adopted PCAOB Auditing Standard No. 6, which will become effective 60 days after SEC approval. This standard and its related amendments update the auditor’s responsibilities to evaluate and report on the consistency of a company’s financial statements and align the auditor’s responsibilities with FASB Statement No. 154, Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3. This standard also improves the auditor reporting requirements by requiring the auditor’s report to recognize a company’s correction of a material misstatement, regardless of whether it involves the application of an accounting principle. This standard also clarifies that the auditor’s report should indicate whether an adjustment to previously issued financial statements results from a change in accounting principle or the correction of a misstatement.

.57 The standard clarifies that the periods covered in the auditor’s evaluation of consistency depend on the periods covered by the auditor’s report on the financial statements. When the auditor reports only on the current period, he or she should evaluate whether the current period financial statements are consistent with those of the preceding period. When the auditor reports on two or more periods, he or she should evaluate consistency between such periods and the consistency of such periods with the period prior thereto if such prior period is presented within the financial statements being reported upon.4

.58 The standard also states that the auditor should evaluate and report on a change in accounting estimate affected by a change in accounting principle like other changes in accounting principle. In addition, the auditor should recognize a change in the reporting entity by including an explanatory paragraph in the auditor’s report, unless the change in reporting entity results from a transaction or event. A change in reporting entity that results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit, does not require recognition in the auditor’s report.

.59 The auditor should evaluate a change in accounting principle to determine whether

- the newly adopted accounting principle is GAAP.
- the method of accounting for the effect of the change is in conformity with GAAP.
- the disclosures related to the accounting change are adequate.
- the company has justified that the alternative accounting principle is preferable.

.60 The PCAOB also clarified that a change in classification in previously issued financial statements does not require recognition in the auditor’s report, unless the change represents the correction of a material misstatement or a change in accounting principle.

.61 In the same release, the PCAOB adopted several amendments to its interim standards relating to standards and interpretations of AU section 328, Auditing Fair Value Measurements and Disclosures; AU section 400, The First, Second, and Third Standards of Reporting; AU section 508, Reports on Audited Financial Statements; and AU section 561, Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report (AICPA, PCAOB Standards and Related Rules, PCAOB Standards, As Amended).

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4 For example, assume that a company presents comparative financial statements covering three years and has a change in auditors. In the first year in which the successor auditor reports, the successor auditor evaluates consistency between the year on which he or she reports and the immediately preceding year. In the second year in which the successor auditor reports, the successor auditor would evaluate the consistency between the two years on which he or she reports and between those years and the earliest year presented.
In these amendments, the PCAOB removed the GAAP hierarchy from its standards as it believes the hierarchy is more appropriately located in the accounting standards. These amendments do not change the principles in AU section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Standards, As Amended), for evaluating fair presentation of the financial statements in conformity with GAAP. FASB has issued FASB Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, which has an effective date of 60 days following the SEC’s approval of the PCAOB amendments to AU section 411. The AICPA Auditing Standards Board (ASB) will coordinate the provisions and effective date of its associated exposure draft with the effective date of the FASB statement.

For more information on the status of this adopted standard and its associated amendments, please visit www.pcaob.org.

**Rules on Periodic Reporting by Registered Accounting Firms**

On June 10, 2008, the PCAOB adopted rules for annual and special reporting of information and events by accounting firms that are registered with the PCAOB. The reporting framework includes two types of reporting obligations. First, each registered firm must annually provide basic information about the firm and the firm’s issuer-related practice during the most recent 12 month period. Information to be reported annually includes, among other things, information about audit reports issued by the firm during the year, certain disciplinary history information about persons who have joined the firm, and information about fees billed to issuer audit clients, in various categories of services, as a percentage of the firm’s total fees billed.

Second, the rules and forms adopted by the PCAOB identify certain events that, if they occur with respect to a registered firm, must be reported by the firm within 30 days. These reportable events range from such things as a change in the firm’s name or contact information to the institution of certain types of legal, administrative, or disciplinary proceedings against a firm or certain categories of individuals.

The PCAOB will make each firm’s annual and special reports available to the public on the PCAOB’s Web site, subject to exceptions for information that satisfies specified criteria for confidential treatment.

The PCAOB has submitted the rules to the SEC for approval. The rules will take effect 60 days after SEC approval. Beginning then, firms will be subject to the special reporting obligations, with the earliest potential special reporting deadline for any firm being 90 days after SEC approval. For all firms, the first annual report will be due by June 30, 2009, for the 12 month period ending March 31, 2009. The full text of the rule, as well as copies of the new reporting forms, can be found at www.pcaobus.org/News_and_Events/News/2008/06-10.aspx.

**PCAOB Proposed Rules and Standards**

**Engagement Quality Review**

On February 26, 2008, the PCAOB proposed a new auditing standard that would supersede its interim concurring partner review requirement, and a conforming amendment to the PCAOB’s interim quality control standards. The proposed standard would apply to all engagements performed in accordance with the standards of the PCAOB.

In addition to requiring certain specified procedures, the proposed standard requires the engagement quality reviewer to assess whether there are areas within the engagement that pose a higher risk that the engagement team failed (1) to obtain sufficient competent evidence or (2) to reach an appropriate conclusion. In such areas, an engagement quality reviewer should evaluate whether the engagement team responded appropriately to the assessed risks, the judgments made were reasonable, and the results of the procedures performed support the engagement team’s overall conclusions.
In addition, the proposed standard includes a new requirement that the engagement quality reviewer must satisfy before providing concurring approval of issuance. Under the proposed standard, the reviewer must not provide concurring approval of issuance if he or she knows, or should know based upon the requirements of the standard, that the engagement team failed to obtain sufficient competent evidence, the engagement team’s overall conclusion or report is inappropriate, or the firm is not independent of its client. Concurring approval of issuance would be required before the firm could grant the client permission to use the engagement report (or communicate a conclusion to a client if no report is issued). The full text of the proposal can be found at www.pcaob.org/Rules/Docket_025/2008-02-26_Release_No_2008-002.pdf.

PCAOB Standing Advisory Group

The PCAOB Standing Advisory Group (SAG) is currently a 36 person panel representing the auditing profession, public companies, investors, and others charged with advising the PCAOB on the establishment of auditing and related professional practice standards. The SAG was established in April 2004 and meets approximately three times a year. Six organizations have been granted observer status at these meetings and include the following:

- FASB
- U.S. Government Accountability Office (GAO)
- International Auditing and Assurance Standards Board (IAASB)
- SEC
- U.S. Department of Labor
- AICPA ASB

The SAG meetings can be heard via webcast, and briefing papers can be accessed at www.pcaob.org/Standards/Standing_Advisory_Group/index.aspx. The following are summaries of the most recent meetings.

February 2008 SAG Meeting

On February 27, 2008, the SAG met to discuss the SEC’s proposal relating to judgments made by financial statement preparers and auditors, accounting firms and auditors’ responsibility to supervise, and global quality control practices. Additional details on each topic are noted in the following list:

- The SAG panel discussed the proposal of the SEC’s Advisory Committee on Improvements to Financial Reporting relating to accounting and auditing judgments. The panel discussed the objectives and elements of the proposal, as well as whether the SEC’s adoption of such a framework would have an effect on public companies’ audits and, if so, what effect.

- Accounting firms and auditors’ responsibility to supervise was also a focus of the group. SAG members were asked to consider whether the current auditing, quality control, and related professional practice standards include sufficient direction concerning the supervision of audit work.

- The SAG also held a panel discussion on global quality control practices. A panel of representatives from global audit networks discussed their quality control practices, including practices in the audits of financial statements prepared in accordance with IFRS. The main purpose of the panel was to foster discussion about global audit networks and their quality control practices to help determine what changes might be needed to be made to SEC Practice Section (SECPS) 1000.45, Appendix K—SECPS Member Firms With Foreign Associated Firms That Audit SEC Registrants (AICPA, PCAOB Standards and Related Rules), or other quality control standards.
October 2007 SAG Meeting

On October 18, 2007, the SAG met to discuss proposed standards setting activities and audit implications of IFRS in U.S. SEC filings. The SAG also heard a working paper presentation from the Office of Research and Analysis. A summary of the meeting is included in the following:

- The Office of the Chief Auditor (OCA) presented the PCAOB’s standards setting priorities. Topics include internal control, independence and principles of reporting, engagement quality review, risk assessment (which includes fraud risk assessment), fair value, the auditor’s use of specialists, related parties, confirmations, and an action plan for review of the PCAOB interim standards. The OCA noted that some of these topics will result in either proposed or final adopted standards or rules in the next 12 months.
- The SAG discussed both the SEC concept release and proposal related to the acceptance of financial statements prepared in accordance with IFRS.
- The working paper discussed was Changes in Market Responses to Financial Statement Restatement Announcements in the Sarbanes-Oxley Era. Specifically, the working paper addressed whether market responses have been different since the enactment of Sarbanes-Oxley, and if so, what were the changes.

The next SAG meeting will be held on October 22–23, 2008. Updated information related to this meeting, including an agenda, will be available at www.pcaob.org/Standards/Standing_Advisory_Group/index.aspx.

PCAOB Staff Audit Practice Alert on Fair Value

On December 10, 2007, the PCAOB issued Staff Audit Practice Alert No. 2, Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, sec. 400 par. .02). The purpose of this practice alert is to remind auditors of their responsibilities for auditing fair value measurements of financial instruments and the use of the work of specialists under the existing standards of the PCAOB. The practice alert focuses on specific matters that are likely to increase audit risk related to the fair value of financial instruments in a rapidly changing economic environment. Although this practice alert focuses on fair value in general, it also draws the auditor’s attention to certain areas of the new fair value accounting standard, FASB Statement No. 157. It also addresses the auditor’s responsibilities when using the work of specialists. The practice alert is divided into four main sections:

- Auditing fair value measurements
- Classification within the fair value hierarchy under FASB Statement No. 157
- Using the work of specialists
- Use of a pricing service

The full text of the practice alert can be accessed at www.pcaob.org/Standards/Staff_Questions_and_Answers/2007/12-10_APA_2.pdf.

PCAOB Inspections

Inspection Frequency Rule

Section 404 of Sarbanes-Oxley requires the PCAOB to conduct inspections of registered public accounting firms. In the inspections, the PCAOB assesses compliance with Sarbanes-Oxley, the rules of the PCAOB, and the rules of the SEC and professional standards in connection with the firm’s performance of audits, issuance of audit reports, and related matters involving issuers. Sarbanes-Oxley requires the PCAOB to conduct those inspections annually for firms that provide audit reports for more than 100 issuers and at least triennially for firms that provide audit reports for fewer than 100 issuers.
The PCAOB makes portions of the inspection reports public, and they can be accessed at www.pcaob.org/Inspections/Public_Reports/index.aspx.

Guidance Regarding Implementation of PCAOB Rule 4012

On December 5, 2007, the PCAOB requested public comment on the proposed policy statement Guidance Regarding Implementation of PCAOB Rule 4012. Rule 4012, Inspections of Foreign Registered Public Accounting Firms, permits the PCAOB to rely on independent audit oversight entities located in the home countries of registered non-U.S. audit firms in connection with required inspections and identifies five broad principles that guide the PCAOB in making a reliance determination. Due to the evolution of auditor oversight throughout the world, the PCAOB is proposing to issue this policy statement, which would permit the PCAOB to place full reliance on the inspection programs of non-U.S. auditor oversight entities. The full text of the release can be found at www.pcaob.org/Inspections/Other/2007/12-05_Release_2007-011.pdf. In addition, all comments received to date regarding this release can be accessed at www.pcaob.org/Inspections/Other/2008/PCAOB_Rule_Comments.pdf.

Report on the PCAOB’s 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms

On October 27, 2007, the PCAOB issued a report discussing observations identified in the course of the PCAOB’s 2004, 2005, and 2006 inspections of registered U.S. firms that were subject to triennial PCAOB inspections. The report discusses areas of the audit where PCAOB inspectors have observed significant or frequent deficiencies in the first PCAOB inspections of triennial firms. The major areas where deficiencies were identified include the following:

- **Revenue.** Firms were found to have not performed any or adequate substantive procedures to test the existence, completeness, and valuation of revenue. They also failed to review representative contracts or appropriately evaluate the specific terms and provisions included in significant contracts. In addition, the PCAOB found issues with firms not testing whether revenue was recognized in the appropriate period. In some instances, the PCAOB also found firms relying on management representations with regards to revenue recognition without obtaining corroboration of those representations. Some firms also failed to address specific accounting pronouncements related to revenue recognition, including EITF Issue No. 99-19, “Reporting Revenue Gross as a Principal versus Net as an Agent”; FASB Statement No. 45, Accounting for Franchise Fee Revenue; and Statement of Position 97-2, Software Revenue Recognition (AICPA, Technical Practice Aids, ACC sec. 10,700).

- **Related party transactions.** Inspection teams have observed deficiencies related to firms’ failures to identify and address the lack of disclosure of related party transactions. They have also identified deficiencies relating to the effectiveness of firms’ testing of the nature, economic substance, and business purpose of transactions with related parties.

- **Equity transactions.** The most common deficiencies in this area relate to the failure of firms to evaluate whether issuer clients had appropriately determined the fair values assigned to equity-based transactions.

- **Business combinations and impairment of assets.** Inspection teams encountered numerous instances of firms’ failure to perform adequate audit procedures to test the allocation of the purchase price and the reasonableness of the estimated fair values assigned to the assets acquired. They also identified instances where firms failed to challenge issuers’ incorrect accounting, and performed inadequate procedures with regards to goodwill and other long-lived assets.

- **Going concern considerations.** The teams observed that some firms failed to perform, or perform adequately, audit procedures related to the entity’s ability to continue as a going concern. Some of these firms failed to identify or evaluate the significance of conditions that indicated an entity may not have been able to continue as a going concern, such as cumulative losses since inception, accumulated capital deficits, and negative working capital. Other firms identified conditions that could affect the issuer’s ability to continue as a going concern, but failed to evaluate management’s
plans to mitigate the effects of such conditions, or failed to obtain information about the likelihood that such plans could be implemented effectively. In addition, some firms failed to evaluate the adequacy of an entity’s disclosure of the going concern conditions and management’s plans to mitigate them.

- **Loans and accounts receivable (including allowance accounts).** In some cases, inspection teams noted that firms failed to circulate confirmation requests or obtain other evidence to assess the existence of accounts receivable. In other instances, firms circulated confirmation requests, but failed to perform sufficient, alternative procedures to address nonresponses or responses with exceptions. There were also instances where firms failed to perform sufficient procedures to conclude whether the allowance for loan losses was reasonable.

- **Service organizations.** The inspection teams observed deficiencies related to firms’ reliance on controls over the information provided by service organizations as well as firms’ use of information produced or processed by service organizations.

- **Use of other auditors.** Deficiencies in this area included firms reporting on the financial statements as principal auditor when their participation was not sufficient to enable them to serve in that capacity, as well as insufficient planning, supervision, review, and addressing of significant audit areas by the firms when other auditors were used as assistants.

- **Using the work of specialists.** Inspectors found instances where the firms failed to perform the necessary procedures with regard to specialists. These include (a) the failure to evaluate the relationship of the specialist to the issuer in circumstances where the specialist has other business relationships with the issuer or otherwise has a relationship that may have a bearing on the specialist’s objectivity; (b) the failure to obtain an understanding of the specialist’s methods and assumptions; or (c) the failure to make appropriate tests of the data the issuer provided to the specialist.

- **Independence.** Inspection teams found several ways in which firms have failed to comply with the SEC and PCAOB independence requirements. There were many instances where a firm’s system of quality control did not appear to provide sufficient assurances that the firm would make or document all required independence communications to its issuer audit client’s audit committee. In addition, the PCAOB found that some agreements between an auditor and its issuer client provided certain types of limits on the auditor’s potential liability, which impair auditor independence under the SEC rules.

- **Concurring partner review.** Some firms failed to ensure their concurring partner reviews were effective.


**PCAOB Accounting Support Fee and Funding Process**

.83 On April 28, 2008, the PCAOB updated its frequently asked questions (FAQs) regarding the accounting support fee and funding process. The statements contained in these FAQs are not rules of the PCAOB, nor have they been approved by the PCAOB. The entire release can be accessed at www.pcaob.org/Support_Fees/SupportFeeFAQ.pdf.

.84 The PCAOB also publishes a list of issuers with no outstanding or past due share of the accounting support fee. This list can be found at www.pcaob.org/Support_Fees/Issuers_Paid.pdf.

**PCAOB Independence Guidance**

*Ethics and Independence Rule 3526*

.85 On April 22, 2008, the PCAOB adopted Ethics and Independence Rule 3526, *Communication with Audit Committees Concerning Independence*, which, if approved by the SEC, would supersede the PCAOB’s interim
independence requirement, Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees, and two related interpretations. This rule requires a registered public accounting firm, before accepting an initial engagement, to describe in writing to the audit committee all relationships between the firm or any of its affiliates and the issuer that may reasonably be thought to bear on the firm’s independence. The PCAOB also adopted an amendment to Rule 3523, Tax Services for Persons in Financial Oversight Reporting Roles (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”), to exclude from the scope of the rule tax services provided during the portion of the audit period that precedes the beginning of the professional engagement period. The full text of the rule can be found at www.pcaob.org/Rules/Docket_017/2008-04-22_Release_2008-003.pdf.

PCAOB Small Business Initiatives

Forum on Auditing in the Small Business Environment

.86 The series of forums on auditing in the small business environment is a program for registered accounting firms and public companies in the small business community to learn more about the work of the PCAOB, specifically the PCAOB inspections process and the effect of new auditing standards. The PCAOB began holding small business forums in 2004. Invited participants are auditors from smaller registered public accounting firms and directors and financial executives of smaller public companies. The program is limited to those groups in the small business environment that are most directly affected by the PCAOB’s oversight responsibilities. The goal of such a format is to ensure that there is ample opportunity for discussion of PCAOB issues facing small business communities between representatives of this sector and PCAOB members and its staff.

.87 The 2008 agenda will include a discussion of practical quality control policies and procedures, and evolving accounting and auditing issues. The discussions will also address the application of certain auditing standards and observations from the PCAOB’s disciplinary orders. In addition, the 2008 agenda will include a discussion of the implementation of PCAOB Auditing Standard No. 5, An Audit of Internal Control over Financial Reporting That is Integrated with an Audit of Financial Statements (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”). The next forum will be held in Chicago September 30–October 1, 2008.

Staff Guidance—Auditing Internal Control Over Financial Reporting for Smaller Public Companies

.88 On October 17, 2007, the PCAOB published for public comment staff guidance on internal control over financial reporting in smaller public companies. This guidance is a key component in the PCAOB’s effort to support the successful implementation of PCAOB Auditing Standard No. 5. The guidance demonstrates how auditors can apply the principles described in the standard and provides examples of approaches to particular audit issues that might arise in audits of smaller, less complex companies. Topics discussed in the staff guidance include the following:

• Entity-level controls
• Risk of management override
• Segregation of duties and alternative controls
• IT controls
• Financial reporting competencies
• Testing controls with less formal documentation

.89 The full text of the preliminary staff views can be found at www.pcaob.org/Standards/Standards_and_Related_Rules/AS5/Guidance.pdf. The CAQ also commented on the proposals and proposed some changes. For a copy of the CAQ comment letter, see http://thecaq.org/newsroom/pdfs/CAQ%20Comment%20Letter%20-%20PCAOB%20Small%20Audit%20Guidance.pdf.
Other PCAOB Initiatives

Implementing PCAOB Auditing Standard No. 5

.90 On March 31, 2008, a PCAOB board member gave a speech on the implementation of PCAOB Auditing Standard No. 5. This speech reiterated the four basic objectives of the standard, as follows:

- Focus auditors on controls that present the greatest risk that a material misstatement will not be prevented or detected
- Eliminate unnecessary procedures
- Make the audit scalable to the size and the complexity of the company
- Rewrite the standard to be shorter and more principles based

.91 The speech also emphasized the critical role that the 2008 inspection process will play in ensuring that PCAOB Auditing Standard No. 5 is being applied as intended by the standard. The inspection process is critical in determining how PCAOB Auditing Standard No. 5 translates into practice. In the speech, the board member stressed he does not want the inspection process to communicate the wrong message, and inspections leadership will therefore be implementing a sophisticated internal controls process to monitor concerns about internal control over financial reporting audits and to make sure that any comments issued to the firms are clear and consistent with the objectives of PCAOB Auditing Standard No. 5. In addition, the PCAOB board member reminded the audience that part of the switch from PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements, to PCAOB Auditing Standard No. 5 was due to concern about restoring the balance between costs and benefits. Therefore, if auditors don’t take advantage of the opportunities for efficiency and the risk-focus in the new standard, the result is likely to be “needless cost and frustration for both companies and auditors.” The full text of the speech can be accessed at www.pcaob.org/News_and_Events/Events/2008/Speech/03-31_Goelzer.aspx.

SEC Speech at the AICPA National Conference on Current SEC and PCAOB Developments

.92 The chief auditor and director of professional standards of the PCAOB gave a speech at the annual AICPA conference on current SEC and PCAOB developments on December 10, 2007. The speech opened with a remark on the “death” of PCAOB Auditing Standard No. 2, and adoption of PCAOB Auditing Standard No. 5, as well as the anticipated benefits of the new standard. In addition, the speech addressed the globalization of professional standards and noted that in the coming year, the PCAOB will consider and seek additional views on whether there is a need for a set of globally accepted auditing standards, how the PCAOB should interact with other auditing standards setters, and how this should fit within the PCAOB’s other priorities. He pointed out that as a result of the standards setting process, there will likely be differences between the standards set by the PCAOB and the equivalent International Standards on Auditing (ISAs) set by the IAASB.

.93 The speech noted the importance of inspections and enforcement activities pointing out that the inspections of the implementation of PCAOB Auditing Standard No. 2 gave the PCAOB valuable information in the development of PCAOB Auditing Standard No. 5. During 2007, the PCAOB published three general reports concerning the procedures, findings, and results of its various inspections. The first report, issued in January 2007, contains observations about auditors’ implementation of auditing standards related to the auditor’s responsibility with regard to the consideration of fraud. The second report, issued in April 2007, contains observations on the second year implementation of PCAOB Auditing Standard No. 2. The final report, issued in October 2007, discusses observations identified in the first three years of inspecting U.S. registered public accounting firms that audit 100 or fewer issuers. The full text of the speech can be accessed at www.pcaob.org/News_and_Events/Events/2007/Speech/12-10_Ray.aspx.
Other Related Developments and Resources

Committee for Sponsoring Organizations of the Treadway Commission

.94 In June 2008, the Committee for Sponsoring Organizations of the Treadway Commission released a draft of its exposure document Guidance on Monitoring Internal Control Systems. The guidance is designed to help organizations monitor the quality of their internal control systems. The comment period for the exposure draft ended August 15, 2008. Further information can be found at www.coso.org/guidance.htm.

CAQ Developments and Alert Highlights

.95 The following are developments of the CAQ since the last edition of this alert. Additional information about the CAQ can be found in the “Resource Central” section of this alert.

U.S. Department of Treasury Study Analyzing the Increase in Public Company Restatements Between 1997 and 2006

.96 The U.S. Department of Treasury commissioned a study in October 2007 called The Changing Nature and Consequences of Public Company Financial Restatements, which was released April 9, 2008. The study examined the characteristics and consequences of financial statement restatements from violations of U.S. GAAP from 1997 to 2006. The study analyzed 6,633 restatements of financial results announced during the study period.

.97 In October 2007, the Treasury issued a press release announcing that numerous studies have pointed to a significant increase in the number of financial restatements during the past few years. Many of these studies attribute the growing number of misstatements to increased management and auditor focus on accurate financial reporting due to the mandates imposed by Sarbanes-Oxley, as well as greater enforcement and review by regulators. Some studies suggest that although some restatements are material, immaterial restatements might pose significant and unwarranted challenges to the capital markets.

.98 As a result, the Treasury commissioned a study to examine the factors triggering public company financial restatements, describe public company financial restatements, analyze the effect of public company financial restatements on investors and capital markets, and evaluate the significance of public company financial restatements.

.99 The following are some highlights of the study findings:

- Restatements during the study period grew nearly 18 fold from 90 in 1997 to 1,577 in 2006. The increase in restatements during this period was driven primarily by companies that do not trade on the major stock exchanges (New York Stock Exchange, American Stock Exchange, and NASDAQ). Nonexchange-listed companies accounted for only 23 percent of all restatements in 1997, but this figure increased to 62 percent by 2006.

- Restatement frequencies began to accelerate in 2001 due, in part, to the economic downturn at that time.

- On average, market reaction to restatements is negative throughout the study period, but, beginning in 2001, the magnitude of market reactions declined notably, which coincided with the number of restatements from 2001 to 2006.

- In certain years during the study period, restatement frequencies and market reactions were associated with several disparate factors, including overall market returns and volatility, regulatory activities, and changes in the mix of underlying accounting issues. With regard to shifts in underlying accounting issues, the study found that
— restatements related to fraud and those affecting revenue tended to have more negative market reactions. However, the percentages of both fraud and revenue restatements declined throughout the decade. Fraud is a factor in 29 percent of all 1997 restatements, but only 2 percent of 2006 restatements. The proportion of revenue restatements also decreased from 41 percent in 1997 to 11 percent in 2006.

— restatements related to accounting for nonoperating expenses, nonrecurring events, and reclassifications typically did not have discernibly negative market reactions. Together, these groups represent about 24 percent of all 1997 restatements, increasing to nearly half of all restatements by the end of the study period.

- During the study period, the average restating company increased in size, but remained similar to a comparison group of nonrestating companies. Companies of differing sizes tended to restate for different accounting issues, and several of the distinctions were consistent with expected variations in the activities of larger versus smaller companies.

- Restating companies were typically unprofitable even before the restatement. In the year prior to announcing a restatement, more than half of the restating companies reported a net loss.


**CAQ Briefing to Discuss Treasury Advisory Committee’s Recommendations for the Auditing Profession**

.101 The Treasury established the Advisory Committee on the Auditing Profession in 2007 to examine the sustainability of a strong and vibrant audit profession. The advisory committee has been holding public meetings since October 2007. More information on the advisory committee, as well as meeting agendas and minutes, can be found at www.treas.gov/offices/domestic-finance/acap/.

.102 On May 21, 2008, the CAQ presented a webinar to discuss its recommendations for the auditing profession. During the 90 minute live Web conference, speakers

- provided an overview and analysis of the Treasury advisory committee’s recommendations in the areas of human capital, firm structure and finances, and concentration and competition.

- explained how citizens can make their views known by submitting a comment to the committee.

- answered questions from the participants.

.103 Comments were due back to the committee by June 13, 2008. You can view the comments received at http://comments.treas.gov/index.cfm?FuseAction=Home.ViewList.

**Highlights of the GAO’s Updated Study on Consolidation and Competition of Public Accounting Firms**

.104 In January 2008, the GAO issued a report entitled Audits of Public Companies Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action. This report is an update of the GAO’s initial report on the consolidation of public accounting firms, which was a study mandated by Congress under Section 701 of Sarbanes-Oxley. The GAO updated its study in its latest issuance of this report as part of a continued effort to assist Congress in reviewing concentration in the market for public company audits.

.105 The GAO concluded in its updated report that in light of limited evidence that the currently concentrated market for large public company audits has created significant adverse effects and the general lack of any proposals that were clearly seen as effective in addressing the risks of concentration or challenges facing smaller firms without serious drawbacks, they found no compelling need to take action. As a result, the report does not contain any recommendations.

Resource Central

.107 The following are various resources that practitioners may find beneficial.

Publications

.108 Practitioners may find the following publications useful with respect to accounting and auditing of public companies. Choose the format best for you—online, print, or CD ROM.

- **AICPA Comprehensive Audit Risk Alert—2008** (product no. 022339kk [paperback], WGE-XX [online], or DGE-XX [CD ROM])
- **Audit Risk Alert Independence and Ethics—2008** (product no. 022479kk [paperback], WIA-XX [online], or DIA-XX [CD ROM])
- **Audit and Accounting Manual** (2008) (product no. 005138kk [paperback], WAM-XX [online], or AAM-XX [loose leaf])
- **Accounting Trends & Techniques, 62nd Edition** (product no. 009900kk [paperback] or WAT-XX [online])
- **PCAOB Standards and Related Rules** (product no. 057208kk [paperback] or WPC-BX [online])

.109 Additional resources for accountants in business and industry are the Financial Reporting Alert series, designed to be used by members of an entity’s financial management and audit committee to identify and understand current accounting and regulatory developments affecting the entity’s financial reporting.

- **Financial Reporting Alert Current Accounting Issues and Risks—2008** (product no. 029208kk)
- **Financial Reporting Alert Not-for-Profit Organizations—Accounting Issues and Risks—2008** (product no. 029207kk)
- **Financial Reporting Alert FASB Codification Developments—2008** (product no. 029209kk)

AICPA reSOURCE: Accounting and Auditing Literature

.110 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm’s needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to the AICPA’s latest Professional Standards, Technical Practice Aids, Audit and Accounting Guides (more than 20), Audit Risk Alerts (more than 15), and Accounting Trends & Techniques. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Continuing Professional Education

.111 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- **AICPA’s Annual Accounting and Auditing Update Workshop** (2008–2009 Edition) (product no. 736184kk [text] or 187192kk [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- **SEC Reporting** (product no. 736775kk [text] or 186756kk [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.
- **Annual Public Company Update: SEC, PCAOB, and AICPA Developments** (product no. 731884kk [text]). Identify recent SEC and PCAOB rules and guidance as well as other developments that affect filings or engagements for this reporting cycle.
With the fast pace of the convergence project, understanding the differences between IFRS and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRS and U.S. GAAP.

- The International Financial Reporting Standards: An Overview (product no. 157220 [online] or 739750HS [DVD]). This course captures a live presentation on IFRS given to the AICPA Board of Directors.

.112 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.113 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA’s flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 for a new subscription and $119 for the annual renewal. Nonmembers pay $369 for each. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some courses currently available related to SEC and PCAOB developments are the following:

- Current SEC and PCAOB Developments—Second Quarter 2008 (course ID kjj)
- SEC Reporting: The SEC and the Laws It Administers (course ID fge)
- SEC Reporting: The Key Rule (course ID fgc)
- 2008 Annual Update—Accounting & Auditing: On the Horizon—Issues for Audits of Public Entities (course ID kep)

.114 To register or learn more, visit www.cpa2biz.com.

Webcasts

.115 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession’s leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.116 The CFO Quarterly Roundtable Series, brought to you each calendar quarter via webcast, covers a broad array of “hot topics” that successful organizations employ and subjects that are important to the CFO’s personal success. From financial reporting and budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.117 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession’s leading experts on what is “hot” at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you “plugged in” to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.118 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.
Hotlines

Accounting and Auditing Technical Hotline

.119 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA’s Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. Beginning January 14, 2008, hotline hours were extended so that the hotline is now available from 9 a.m. to 8 p.m. on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing+Accounting+Auditing+Technical+Help/.

Ethics Hotline

.120 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA’s Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077.

Annual Conference

.121 The AICPA sponsors an annual National Conference on Current SEC and PCAOB Developments in December each year. The three-day conference is designed to provide comprehensive SEC and PCAOB updates directly from the regulators. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

AICPA Launches IFRS.com Web Site

.122 In May 2008, the AICPA launched a new Web site, www.ifrs.com, to provide current information about developments in international convergence. The growing acceptance of IFRS as a basis for U.S. financial reporting represents a fundamental change for the U.S. accounting profession. Acceptance of a single set of high-quality accounting standards for worldwide use by public companies has been gaining momentum around the globe for the past few years.

.123 Developed by the AICPA, in partnership with its marketing and technology subsidiary, CPA2Biz, IFRS.com provides a comprehensive set of resources for accounting professionals, auditors, financial managers, audit committees, and other users of financial statements.

.124 The Web site features tools and resources to help CPAs get acquainted with IFRS, the surrounding issues, and available support. Resources include a history of convergence, a high-level overview of the differences between IFRS and U.S. GAAP, FAQs, articles, textbooks, CPE courses and live conference training, helpful links, and assistance for audit committee members.

SEC Research

.125 The SEC has posted two useful guides to its Web site. The first guide provides an overview of how to research the federal securities laws through the SEC Web site and has been provided by the SEC as a service to investors and members of the public. This guide can be accessed at www.sec.gov/investor/pubs/securitieslaws.htm. The second guide provides information on how to research public companies through Electronic Data Gathering Analysis and Retrieval (EDGAR) on the SEC Web site by providing tips and answers to FAQs. EDGAR provides free public access to corporate information and SEC filings. The guide states that to use EDGAR effectively, you should know which categories of information appear in which SEC filings and which search methods would work best. In addition, you should also understand the limitations of EDGAR, which this guide can help explain. This guide can be accessed at www.sec.gov/investor/pubs/edgarguide.htm.
The Center for Audit Quality

.126 The CAQ, which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ’s mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession’s core values of integrity, objectivity, honesty, and trust.

.127 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit http://thecaq.aicpa.org.

The CAQ SEC Regulations Committee

.128 The CAQ SEC Regulations Committee meets periodically with the staff of the SEC to discuss emerging technical accounting and reporting issues related to SEC rules and regulations. The mission of the SEC Regulations Committee is to protect investors by improving the quality of public company financial reporting by identifying, discussing, and facilitating resolution of issues relating to the promulgation, interpretation, and application of SEC rules, regulations, and policies with the assistance of the SEC staff, and communicating those matters publicly on a timely basis. You can view meeting agendas, highlights, and discussion documents at http://thecaq.org/resources/secregs.htm.

The International Practices Task Force

.129 The International Practices Task Force (IPTF) is a task force of the CAQ SEC Regulations Committee. IPTF also meets periodically with the staff of the SEC to discuss and focus on international emerging technical accounting and reporting issues related to SEC rules and regulations. The mission of the IPTF is to protect investors by improving the quality of public company financial reporting by identifying, discussing, and facilitating resolution of issues relating to the promulgation, interpretation, and application of SEC rules, regulations, and policies with the assistance of the SEC staff, and communicating those matters publicly on a timely basis. Meeting highlights, agendas, and discussion papers can be accessed at http://thecaq.org/resources/iptf.htm.

* * * *

.130 This Audit Risk Alert replaces the SEC and PCAOB Alert—2007/08.

.131 The SEC and PCAOB Alert is published annually. As you encounter relevant issues that you believe warrant discussion in next year’s Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to killuzzi@aicpa.org or write to

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AICPA  
220 Leigh Farm Road  
Durham, NC 27707-8110

[The next page is 9000-211.]
AAM Section 8290

Understanding the New Auditing Standards Related to Risk Assessment

NOTICE TO READERS
UNDERSTANDING THE NEW AUDITING STANDARDS RELATED TO RISK ASSESSMENT

This Audit Risk Alert is intended to provide auditors with an overview of the new risk assessment standards to be used in the planning and performance of a financial statement audit.

This publication is an Other Auditing Publication as defined in AU section 150, Generally Accepted Auditing Standards (AICPA, Professional Standards, vol. 1). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Written by Michael J. Ramos, CPA
Edited by Lori L. Pombo, CPA
Technical Manager
Accounting and Auditing Publications

Acknowledgments

The AICPA Accounting and Auditing Publications staff express our special thanks to Hiram Hasty, CPA, who made extensive contributions to this publication. His knowledge of the risk assessment standards and auditing in general was invaluable. In addition, the staff expresses our thanks to Chuck Landes, CPA, for his indispensable review of this publication and to Lyn Graham, CPA, for working closely with the author on key aspects of the risk assessment standards.

Introduction

.01 This audit Alert provides a summary of eight Statements on Auditing Standards (SASs) that provide extensive guidance on how you should apply the audit risk model in the planning and performance of a financial statement audit. These SASs were issued in March 2006 and become effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted. While the time period between the issuance and effective date of the standards may seem long, you should not underestimate the standards’ significance and the far-reaching effect they will have on your audits.

.02 The eight SASs consist of:

1 Statements on Auditing Standards issued by the Auditing Standard Board are applicable to audits of privately held entities and other nonissuers. The term issuer means entities that are subject to the rules and regulations of the U.S. Securities and Exchange Commission and the Sarbanes-Oxley Act of 2002.
The Auditing Standards Board (ASB) believes that the SASs represent a significant strengthening of auditing standards that will improve the quality and effectiveness of audits. The primary objective of the SASs is to enhance your application of the audit risk model in practice by requiring, among other things:

- A more in-depth understanding of your audit client and its environment, including its internal control. This knowledge will be used to identify the risk of material misstatement in the financial statements (whether caused by error or fraud) and what the client is doing to mitigate them.
- A more rigorous assessment of the risk of material misstatement of the financial statements based on that understanding.
- Improved linkage between the assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.

The development of these SASs was undertaken in response to recommendations to the ASB made by the former Public Oversight Board’s Panel on Audit Effectiveness. In addition, the major corporate failures of the past several years have undermined the public’s confidence in the effectiveness of audits and led to an intense scrutiny of the work of auditors, and the development of the SASs also have been influenced by these events.

How the Risk Assessment Standards Affect Current Practice

The SASs incorporate many of the underlying concepts and detailed performance requirements that exist in the current standards. However, the SASs do create significant new requirements for auditors.

In most cases, implementation of the SASs will result in an overall increased work effort by the audit team. It also is anticipated that, to implement the SASs appropriately, many firms will have to make significant revisions to their audit methodologies and train their personnel accordingly. To ease the implementation process, it is recommended that firms adopt at least some of the provisions of the standards in advance of the required implementation date.

How This Alert Is Organized

This Alert is organized into three different parts.

- Part One: Key Provisions of the SASs and How They Differ From Current Standards. This part provides a summary of some of the key provisions of the SASs and how they differ, if at all, from current audit standards.
Part One: Key Provisions of the SASs and How They Differ From Current Standards

This section discusses the key provisions of each of the SASs and provides a summary of how each of the SASs differs, if at all, from the current AICPA generally accepted audit standards.

SAS No. 104, Amendment to Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures (“Due Professional Care in the Performance of Work”)

SAS No. 105, Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards

<table>
<thead>
<tr>
<th>Key Provisions</th>
<th>How the SAS Differs From Current Standards</th>
</tr>
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<tbody>
<tr>
<td>• SAS No. 104 defines reasonable assurance as a “high level of assurance.”</td>
<td>• SAS No. 104 clarifies the meaning of reasonable assurance.</td>
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</table>

• Previous guidance considered the understanding of the entity to be a part of audit planning, and emphasized that the understanding of internal control also was primarily part of audit planning.

• By stating that the purpose of your understanding of the entity and its internal control is part of assessing the risk of material misstatement, SAS No. 105 essentially considers this understanding to provide audit evidence that ultimately supports your opinion on the financial statements.

• The new standard emphasizes the link between understanding the entity, assessing risks, and the design of further audit procedures. It is anticipated that “generic” audit programs will not be an appropriate response for all engagements because risks vary between entities.
Key Provisions | How the SAS Differs From Current Standards
--- | ---
| The term *further audit procedures*, which consists of test of controls and substantive tests, replaces the term *tests to be performed* in recognition that risk assessment procedures are also performed.
| The term *audit evidence* replaces the term *evidential matter*.

SAS No. 106, *Audit Evidence* .11

<table>
<thead>
<tr>
<th>Key Provisions</th>
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| SAS No. 106 defines *audit evidence* as “all the information used by the auditor in arriving at the conclusions on which the audit opinion is based.” | Previous guidance did not define audit evidence.
SAS No. 106 also describes basic concepts of audit evidence.
The term *sufficient, appropriate audit evidence*, defined in SAS No. 106, replaces the term *sufficient, competent evidence*.
| SAS No. 106 recategorizes assertions by classes of transactions, account balances, and presentation and disclosure; expands the guidance related to presentation and disclosure; and describes how the auditor uses relevant assertions to assess risk and design audit procedures. | SAS No. 106 recategorizes assertions to add clarity.
*Assertion relating to presentation and disclosure* has been expanded and includes a new assertion that information in disclosures should be “expressed clearly” (understandability).
| SAS No. 106 defines *relevant assertions* as those assertions that have a meaningful bearing on whether the account is fairly stated. | The term *relevant assertions* is new, and it is used repeatedly throughout SAS No. 106.
| SAS No. 106 provides additional guidance on the reliability of various kinds of audit evidence. | The previous standard included a discussion of the competence of evidential matter and how different types of audit evidence may provide more or less valid evidence. SAS No. 106 expands on this guidance.
| SAS No. 106 identifies “risk assessment procedures” as audit procedures performed on all audits to obtain an understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement at the financial statement and relevant assertion levels. | SAS No. 106 introduces the concept of risk assessment procedures, which are necessary to provide a basis for assessing the risk of material misstatement. The results of risk assessment procedures, along with the results of further audit procedures, provide audit evidence that ultimately supports the auditor’s opinion on the financial statements.
| SAS No. 106 provides that evidence obtained by performing risk assessment procedures, as well as that obtained by performing tests of controls and substantive procedures, is part of the... | (continued)
Key Provisions | How the SAS Differs From Current Standards
--- | ---
evidence the auditor obtains to draw reasonable conclusions on which to base the audit opinion, although such evidence is not sufficient in and of itself to support the audit opinion. | • Risk assessment procedures include:
--- |
| SAS No. 106 describes the types of audit procedures that the auditor may use alone or in combination as risk assessment procedures, tests of controls, or substantive procedures, depending on the context in which they are applied by the auditor. | • Inquiries of management and others within the entity
--- |
| SAS No. 106 includes guidance on the uses and limitations of inquiry as an audit procedure. | • Observation and inspection
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SAS No. 106, *Audit Risk and Materiality in Conducting an Audit*

| Key Provisions | How the SAS Differs From Current Standards
--- | ---
• The auditor must consider audit risk and must determine a materiality level for the financial statements taken as a whole for the purpose of: 1. Determining the extent and nature of risk assessment procedures. 2. Identifying and assessing the risk of material misstatement. 3. Determining the nature, timing, and extent of further audit procedures. 4. Evaluating whether the financial statements taken as a whole are presented fairly, in conformity with generally accepted accounting principles. | • Previous guidance said that auditors “should consider” audit risk and materiality for certain specified purposes. SASs state that the auditor “must” consider.
--- |
• Combined assessment of inherent and control risks is termed the risk of material misstatement. | • New guidance explicitly states that audit risk and materiality are used to identify and assess the risk of material misstatement.
--- |
• The auditor should assess the risk of material misstatement as a basis for further audit procedures. Although that risk assessment is a judgment rather than a precise measurement of risk, the auditor should have an appropriate basis for that assessment. | • SAS No. 107 consistently uses the term *risks of material misstatement*, which often is described as a combined assessment of inherent and control risk. However, auditors may make separate assessment of inherent risk and control risks.
--- |
• SAS No. 107 states that the auditor should have and document an appropriate basis for the audit approach.
--- |
• These two provisions of the risk assessment standards effectively eliminate the ability of the auditor to assess control risk “at the maximum”
Key Provisions | How the SAS Differs From Current Standards
---|---
• Assessed risks and the basis for those assessments should be documented. | without having a basis for that assessment. In other words, you can no longer “default” to maximum control risk.

• The auditor must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management. | • SAS No. 107 provides additional guidance on communicating misstatements to management.
• SAS No. 107 provides additional specific guidance on how to determine this threshold.

• The auditor should request management to respond appropriately when misstatements (known or likely) are identified during the audit. | • SAS No. 107 provides specific guidance regarding the appropriate auditor’s responses to the types of misstatements (known or likely) identified by the auditor.

**SAS No. 108, Planning and Supervision**

.13

<table>
<thead>
<tr>
<th>Key Provisions</th>
<th>How the SAS Differs From Current Standards</th>
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<tr>
<td>SAS No. 108 provides guidance on:</td>
<td>• Much of the guidance provided in SAS No. 108 has been consolidated from several existing standards.</td>
</tr>
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</table>
• Appointment of the independent auditor. | • However, SAS No. 108 provides new guidance on preliminary engagement activities, including the development of an overall audit strategy and an audit plan. |
• Establishing an understanding with the client. | — The overall audit strategy is what previously was commonly referred to as the audit approach. It is a broad approach to how the audit will be conducted, considering factors such as the scope of the engagement, deadlines for performing the audit and issuing the report, and recent financial reporting developments. |
• Preliminary engagement activities. | — The audit plan is more detailed than the audit strategy and is commonly referred to as the audit program. The audit plan describes in detail the nature, timing, and extent of risk assessment and further audit procedures you perform in an audit. |
• The overall audit strategy. | • SAS No. 108 states that you should obtain a written understanding with your client. |
• The audit plan. | |
• Determining the extent of involvement of professionals possessing specialized skills. | |
• Using a professional possessing information technology (IT) skills to understand the effect of IT on the audit. | |
• Additional considerations in initial audit engagements. | |
• Supervision of assistants. | |
## SAS No. 109, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

### Key Provisions

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<tr>
<th>Key Provisions</th>
<th>How the SAS Differs From Current Standards</th>
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<tbody>
<tr>
<td>• SAS No. 109 describes audit procedures that the auditor should perform to</td>
<td>• The auditor should perform “risk assessment procedures” to gather information and gain an understanding</td>
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<tr>
<td>obtain the understanding of the entity and its environment, including its</td>
<td>of the entity and its environment. These procedures include inquiries, observation, inspection, and</td>
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<tr>
<td>internal control.</td>
<td>analytical procedures. Previous standards did not describe the procedures that should be performed to gain</td>
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<td></td>
<td>an understanding of the client.</td>
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<td></td>
<td>• Information about the entity may be provided by a variety of sources, including knowledge about the entity</td>
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<td>gathered in previous audits (provided certain conditions are met), and the results of client acceptance and</td>
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<td>continuance procedures.</td>
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<td></td>
<td>• SAS No. 109 also directs the auditor to perform a variety of risk assessment procedures, and it describes</td>
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<td></td>
<td>the limitations of inquiry.</td>
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<td>• The audit team should discuss the susceptibility of the entity’s financial</td>
<td>• Previous standards did not require a “brainstorming” session to discuss the risk of material misstatements.</td>
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<tr>
<td>statements to material misstatement.</td>
<td>SAS No. 109 requires such a brainstorming session, which is similar (and may be performed together with) the</td>
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<tr>
<td></td>
<td>brainstorming session to discuss fraud.</td>
</tr>
<tr>
<td>• The purpose of obtaining an understanding of the entity and its environment,</td>
<td>• SAS No. 109 directly links the understanding of the entity and its internal control with the assessment of</td>
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<tr>
<td>including its internal control, is to identify and assess “the risk of</td>
<td>risk and design of further audit procedures. Thus, the understanding of the entity and its environment,</td>
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<tr>
<td>material misstatement” and design and perform further audit procedures</td>
<td>including its internal control, provides the audit evidence necessary to support the auditor’s assessment</td>
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<tr>
<td>responsive to the assessed risk.</td>
<td>of risk.</td>
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<tr>
<td>• SAS No. 109 states the auditor should assess the risk of material misstatement</td>
<td>• The previous standard included the concept of assessing risk at the financial statement level, but SAS</td>
</tr>
<tr>
<td>at both the financial statement and relevant assertion levels.</td>
<td>No. 109 provides expanded and more explicit guidance.</td>
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<td></td>
<td>• SAS No. 109 also directs the auditor to determine how risks at the financial statement level may result in</td>
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<td></td>
<td>risks at the assertion level.</td>
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<tr>
<td>• SAS No. 109 provides directions on how to evaluate the design of the entity’s</td>
<td>• Under the previous standard, the primary purpose of gaining an understanding of internal control was to</td>
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<tr>
<td>controls and determine whether the controls are adequate and have been</td>
<td>plan the audit. Under SAS No. 109, your understanding of internal control is used to assess risks. Thus, the</td>
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<td>implemented.</td>
<td>(continued)</td>
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### Key Provisions

<table>
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<tr>
<th>How the SAS Differs From Current Standards</th>
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<tr>
<td>understanding of internal control provides audit evidence that ultimately supports the auditor’s opinion on the financial statements.</td>
</tr>
<tr>
<td>The previous standard directs the auditor to obtain an understanding of internal control as part of obtaining an understanding of the entity and its environment. SAS No. 109 requires auditors to evaluate the design of controls and determine whether they have been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements. It is anticipated that this phase of the audit will require more work than simply gaining understanding of internal control.</td>
</tr>
<tr>
<td>Previous standard did not include the concept of “significant risks.”</td>
</tr>
<tr>
<td>Significant risks exist on most engagements.</td>
</tr>
<tr>
<td>The auditor should gain an understanding of internal control and also perform substantive procedures for all identified significant risks. Substantive analytical procedures alone are not sufficient to test significant risks.</td>
</tr>
<tr>
<td>The guidance provided by SAS No. 109 relating to documentation is significantly greater than that provided by previous standards.</td>
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<tr>
<td>Part three of this Alert lists the documentation requirements of the SASs.</td>
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### SAS No. 110, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained

### Key Provisions

<table>
<thead>
<tr>
<th>How the SAS Differs From Current Standards</th>
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<tbody>
<tr>
<td>SAS No. 110 provides guidance on determining overall responses to address the risk of material misstatement at the financial statement level and the nature of those responses.</td>
</tr>
<tr>
<td>The concept of addressing the risk of material misstatement at the financial statement level and developing an appropriate overall response is similar to the requirement in previous standards relating to the consideration of audit risk at the financial statement level. However, that guidance was placed in the context of audit planning. SAS No. 110 “repositions” your consideration of risk at the financial statement level so you make this assessment as a result of and in</td>
</tr>
<tr>
<td>Key Provisions</td>
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<td>-------------------------------------------------------------------------------</td>
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<tr>
<td>conjunction with your performance of risk assessment procedures. In some cases, this assessment may not be able to be made during audit planning.</td>
</tr>
<tr>
<td>- The list of possible overall responses to the risk of material misstatement at the financial statement level also has been expanded.</td>
</tr>
<tr>
<td>- Further audit procedures, which may include tests of controls, or substantive procedures should be responsive to the assessed risk of material misstatement at the relevant assertion level.</td>
</tr>
<tr>
<td>- SAS No. 110 provides guidance on matters the auditor should consider in determining the nature, timing, and extent of such audit procedures.</td>
</tr>
<tr>
<td>- SAS No. 110 states that the nature of further audit procedures is of most importance in responding to your assessed risk of material misstatement. That is, increasing the extent of your audit procedures will not compensate for procedures that do not address the specifically identified risks of misstatement.</td>
</tr>
<tr>
<td>- SAS No. 110 states that you should perform certain substantive procedures on all engagements. These procedures include:</td>
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(continued)
SAS No. 111, Amendment to Statement on Auditing Standards No. 39, Audit Sampling

<table>
<thead>
<tr>
<th>Key Provisions</th>
<th>How the SAS Differs from Current Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>● SAS No. 111 provides guidance relating to the auditor’s judgment about establishing tolerable misstatement for a specific audit procedure and on the application of sampling to tests of controls.</td>
<td>● SAS No. 111 provides enhanced guidance on tolerable misstatement. In general, tolerable misstatement in an account should be less than materiality to allow for aggregation in final assessment.</td>
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</tbody>
</table>

Part Two: Fundamental Concepts

The SASs describe a process for applying the audit risk model to gather audit evidence and form an opinion about your client’s financial statements. To apply this process appropriately, you will need to have a working knowledge of the key concepts upon which it is built. Those concepts include the following.

● The meaning of reasonable assurance
● Audit risk and the risk of material misstatement
● Materiality and tolerable misstatement
● Financial statement assertions
● Internal control
● Information technology
● Audit evidence

This part of the Alert provides a summary of these key concepts and a description of how they are used.

Reasonable Assurance

The auditing standards make numerous references to your responsibility for obtaining “reasonable assurance.” For example, your audit opinion states that generally accepted auditing standards require you to “obtain reasonable assurance about whether the financial statements are free of material misstatement.” “Reasonable assurance” is the fundamental threshold you use to design and perform your audit procedures. For this reason, it is important that you have a working knowledge of the term.
SAS No. 104 clarifies that reasonable assurance is a high, but not absolute, level of assurance. Put another way, you must plan and perform your audit in such a way to obtain sufficient appropriate audit evidence to reduce audit risk to a low level. Although “reasonable assurance” is a high level of assurance, it is not absolute assurance. Absolute level of assurance is not attainable because an auditor does not examine 100 percent of the entity’s transactions or events and because of the limitations of the entity’s internal control.

Audit Risk and the Risk of Material Misstatement

Audit risk (AR) is the risk that the financial statements are materially misstated and you fail to detect such a misstatement or appropriately modify your opinion. You should perform your audit to reduce audit risk to a low level. You need to consider audit risk at all stages of your audit.

Audit risk is a function of two components:

1. Risk of material misstatement (RMM), which is the risk that an account or disclosure item contains a material misstatement. The risk of material misstatement is a combination of inherent and control risk.
2. Detection risk, which is the risk that you will not detect such misstatements in an account or disclosure item.

Reducing audit risk to a low level requires you to:

1. Assess the risk of material misstatement.
2. Based on that assessment, design and perform further audit procedures to reduce audit risk to an appropriate low level.

Assessing the Risk of Material Misstatement

The risk of material misstatement exists independently of detection risk. Many factors affect the risk of material misstatement, including the following.

- The client’s industry, its regulatory environment, and other external factors
- The nature of the entity, for example, its operations, ownership, and financing
- The client’s objectives, strategies, and related business risks
- How client management measures and reviews the company’s financial performance
- The client’s internal control, which includes the selection and application of accounting policies

Thus, the first step in assessing the risk of material misstatement is to gather information and gain an understanding of these and other items that create risks. Part Three of this Alert describes an audit process that begins with your gaining an understanding of these matters.

The risk of material misstatement may reside at either the financial statement level or the assertion level.

- Financial statement-level risks potentially affect many different assertions. For example, a lack of qualified personnel in financial reporting roles (an element of the client’s control environment) may affect many different accounts and several assertions.
- Assertion-level risks are limited to a single assertion, for example, the valuation of inventory or the occurrence of sales.
Your response to assessed risks will differ depending on whether they reside at the financial statement or assertion level.

- Financial statement-level risks typically require an overall response, such as providing more supervision to the engagement team or incorporating additional elements of unpredictability in the selection of your audit procedures.
- Assertion-level risks are addressed by the nature, timing, and extent of further audit procedures.

For this reason, you should assess the risk of material misstatement at both the financial statement and the assertion level.

Your assessment of the risk of material misstatement (at both the financial statement and the assertion level) should be directly linked to the design and performance of further audit procedures. For example, if your understanding of the client, its environment, and its internal control lead you to assess that there is a high inherent risk that inventory quantities could be misstated, you would design tailored further audit procedures to specifically respond to that risk.

To perform audit procedures that are appropriately responsive to your assessed risks, you should define these risks in a way that incorporates the unique circumstances at the client. Generic checklists and standard audit programs may serve as a starting point for helping you to understand and assess risk, but to be truly effective, these generic audit tools need to be tailored to the specific circumstances of your client.

The process for applying the audit risk model, which is summarized in Part Three of this Alert, describes in more detail how you should link your assessment of risk to the design and performance of further audit procedures.

Risks of Material Misstatement at the Assertion Level. At the assertion level, the risk of material misstatement consists of two components:

- Inherent risk (IR), which is the susceptibility of an assertion to a material misstatement, assuming that there are no related controls. Inherent risk is greater for some assertions and related account balances, classes of transactions, and disclosures than for others.
- Control risk (CR), which is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the client’s internal control. Control risk is a function of the effectiveness of the design and operation of the client’s internal control.

Detection Risk

Detection risk is the risk that you will not detect a material misstatement that exists in an assertion. It is a function of the nature, timing, and effectiveness of audit procedures and how you apply them.

Detection risk relates to your substantive audit procedures and is managed by how you respond to the risk of material misstatement at both the financial statement and the assertion level.

- Financial statement-level risks. Your responses to financial statement-level risks may include assignment of more experienced personnel to the engagement team, emphasizing of the application of professional skepticism, and providing more supervision and review of the audit work performed. Appropriate choices related to these matters will help you mitigate the risks that you might select an inappropriate audit procedure, misapply audit procedures, or misinterpret the results.
- Assertion-level risks. In response to assertion-level risks you will determine the nature, timing, and extent of your further audit procedures that are appropriate to respond to the assessed risk.

Thus, the effectiveness of further audit procedures depends on whether you have:
1. Acquired a sufficient depth and breadth of understanding of your client to make an informed assessment of the risk of material misstatements.

2. Used your assessment of the risks of material misstatement to drive the nature, timing, and extent of your further audit procedures.

An Inverse Relationship Between the Risk of Material Misstatement and Detection Risk. At the assertion level, detection risk has an inverse relationship to the risk of material misstatement. The greater the risk of material misstatement, the less the detection risk that you should be willing to accept. Put another way, the greater the risk of material misstatement, the more reliable your substantive tests should be.

Conversely, when the risk of material misstatement is low, you can accept a greater level of detection risk. However, you are always required to perform substantive tests on all relevant assertions related to each material account balance, class of transactions, and disclosure, regardless of your assessment of the risk of material misstatement.

The model AR = RMM x DR expresses the general relationship of audit risk and its components. You may find this model useful when planning appropriate risk levels for your audit procedures, keeping in mind your overall desire to reduce audit risk to an appropriate low level.

Materiality and Tolerable Misstatement

The Concept of Materiality

The concept of materiality recognizes that some matters are more important for the fair presentation of the financial statements than are others. In performing your audit, you are concerned with matters that could be material to the financial statements. Your responsibility is to plan and perform the audit to obtain reasonable assurance that material misstatements, whether caused by error or fraud, are detected.

Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information, defines materiality as “the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed by the omission or misstatement.” Thus, materiality is influenced by your perception of the needs of financial statement users who will rely on the financial statements to make judgments about your client’s financial position and results of operations.

How Materiality Is Used in Your Audit

Though defined by the accounting literature, materiality also is an audit concept of critical importance. Audit materiality represents the maximum amount that you believe the financial statements could be misstated and still fairly present the client’s financial position and results of operations. Audit materiality affects:

1. The nature, timing, and extent of audit procedures. During audit planning, you should determine a materiality level for the financial statements taken as a whole. This initial determination of materiality will help you:
   — Make judgments when identifying and assessing the risk of material misstatement
   — Determine the nature, timing, and extent of your further audit procedures
2. The evaluation of audit findings. To form an opinion about the financial statements, you must evaluate audit findings and determine whether the misstatements that are not corrected by the client, individually or in the aggregate, are material to the financial statements.

Quantitative and Qualitative Considerations

.39 Although materiality commonly is expressed in quantitative terms, your determination of materiality is a matter of professional judgment that includes both quantitative and qualitative considerations. During the course of your audit, you should be alert for misstatements that could be qualitatively material. However, it ordinarily is not practical to design audit procedures to detect misstatements that qualitatively are material, and for that reason, materiality used for planning purposes considers primarily quantitative matters.

Tolerable Misstatement

.40 During audit planning you must determine an initial level of materiality for the purposes of designing and performing your audit procedures. This initial determination of materiality is determined for the financial statements taken as a whole. However, in designing your audit procedures, you should take into account the possibility that several misstatements of amounts less than financial statement materiality could—in the aggregate—result in a material misstatement of the financial statements. That is, errors in an account or disclosure may still exist and your audit procedures may fail to detect them. For that reason, you need to allow for these undetected misstatements that may exist. You build this allowance into the overall audit strategy process by setting tolerable misstatement.

.41 Tolerable misstatement (also referred to as tolerable error) is defined as the maximum error in a population (for example, the class of transactions or account balance) that you are willing to accept. Tolerable misstatement normally is lower than materiality for the financial statements as a whole. For each class of transactions, account balance, and disclosure, you should determine at least one level of tolerable misstatement.

.42 For example, if for planning purposes you determined materiality to be $100,000, you could set tolerable misstatement at $60,000. Then, you would use this tolerable misstatement level to determine the nature, timing, and extent of your further audit procedures. You could use different levels of tolerable misstatement for other account balances, classes of transactions, or assertions. See AU section 350, Audit Sampling, of volume 1 of the AICPA Professional Standards for more guidance about tolerable misstatement.

Financial Statement Assertions

Why Financial Statement Assertions Are Important

.43 Your audit results in an opinion of the financial statements taken as a whole. However, to reach this opinion of the financial statements, most of your audit procedures should be directed at a much more detailed level, the assertion level.

.44 Assertions are management’s implicit or explicit representations regarding the recognition, measurement, presentation, and disclosure of information in the financial statements and related disclosures. Assertions fall into three categories: (1) classes of transactions, (2) account balances, and (3) presentation and disclosure.

.45 For example, by presenting the information “Cash . . . $XXX” in the financial statements, management implies that:
- The cash truly exists and company has the right to use it.
- The amount presented represents all the company’s cash.
- The amount presented is accurate.

.46 Many of your audit procedures are performed not on the financial statements taken as a whole nor even at the account or disclosure level, but rather, they are directed at individual assertions.

.47 Relating identified risks of material misstatement to misstatements that might occur at the assertion level is necessary for you to properly link assessed risks to further audit procedures.

.48 The table titled “Categories of Assertions” provides a summary of how assertions might be grouped into various categories. You may express these assertions differently, as long as your descriptions encompass all the aspects described in the table.

<table>
<thead>
<tr>
<th>Categories of Assertions</th>
<th>Description of Assertions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Classes of Transactions and Events During the Period</td>
<td>Account Balances at the End of the Period</td>
</tr>
<tr>
<td>Occurrence/Existence</td>
<td>Transactions and events that have been recorded have occurred and pertain to the entity.</td>
</tr>
<tr>
<td>Rights and Obligations</td>
<td>—</td>
</tr>
<tr>
<td>Completeness</td>
<td>All transactions and events that should have been recorded have been recorded.</td>
</tr>
<tr>
<td>Accuracy/Valuation and Allocation</td>
<td>Amounts and other data relating to recorded transactions and events have been recorded appropriately.</td>
</tr>
<tr>
<td>Cut-off</td>
<td>Transactions and events have been recorded in the correct accounting period.</td>
</tr>
<tr>
<td>Classification and Understandability</td>
<td>Transactions and events have been recorded in the proper accounts.</td>
</tr>
</tbody>
</table>

**How You Use Assertions in Your Audit**

.49 Most of your tests of controls and substantive audit procedures are directed at specific assertions. For example, confirmation of receivables provides strong, direct evidence about the existence of those receivables.
and it may provide some evidence about accuracy of the gross balance. However, confirmations alone are not sufficient appropriate audit evidence to test the valuation of receivables, and the auditor should perform other appropriate procedures, such as looking at subsequent cash receipts and applying analytical procedures in testing the allowance for doubtful accounts. For this reason, to establish a clear link between your assessment of the risk of material misstatement and further audit procedures, your risk assessment procedures should be performed at the assertion level as well.

Internal Control

Definition and Description of Internal Control

.50 Internal control is a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance about the achievement of the entity’s objectives. These objectives fall into three categories: financial reporting, operations, and compliance with laws and regulations. In general, when performing a financial statement audit, you are most concerned with the client’s financial reporting objectives, which relate to the preparation of audited financial statements.

.51 In trying to achieve its objectives, your client faces certain risks. Internal control helps the entity achieve its objectives by mitigating the risk of “what can go wrong” in the pursuit of its objectives. Thus, there is a direct link between the entity’s objectives, the risks to achieving those objectives, and internal control. Your assessment of internal control is a consideration of whether the controls mitigate financial reporting risks.

.52 Internal control consists of five interrelated components:

1. Control environment sets the tone of an organization, influencing the control-consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

2. Entity’s risk assessment is the entity’s identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.

3. Information and communication systems support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

4. Control activities are the policies and procedures that help ensure that management directives are carried out.

5. Monitoring is a process that assesses the quality of internal control performance over time.

.53 This division of internal control into five components provides a useful framework for you to consider how different aspects of your client’s internal control may affect your audit. You are not required to classify controls into a particular component. Rather, your understanding of internal control involves determining whether and how a specific control may prevent or detect and correct material misstatements.

Controls May Be Pervasive to the Entity or Restricted to an Account or Assertion

.54 Your client’s financial reporting risks (and therefore its controls) may relate to one of the following:

1. To specific classes of transactions, account balances, and disclosures

2. More pervasively to the financial statements taken as a whole (And potentially the risks may affect many assertions.)
For example, a weak control environment potentially affects many assertions and therefore is considered to operate at the financial statement level. In contrast, a control to ensure that all valid purchases are captured and recorded is restricted to specific accounts and classes of transactions and thus operates at the assertion level.

Understanding whether a control is restricted to specific classes of transactions, account balances, or disclosures or pertains pervasively to the financial statements will help you:

1. Design appropriate audit procedures to obtain information about the design of the control and whether it has been placed in operation
2. Assess the risk of material misstatement in the financial statements
3. Design substantive audit procedures
4. Assess the results of the tests of operating effectiveness of controls, if any

**Control Design**

The evaluation of internal control design involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements.

On every audit you should evaluate the design of internal control and determine whether controls have been implemented over all relevant assertions related to each material account balance, class of transactions, or disclosures.

**Control Operations**

The concept of the effective operation of controls is different from their design and implementation. The operating effectiveness of controls involves the consideration of:

- How controls were applied during the audit period
- The consistency with which they were applied
- By whom they were applied

To assess the operating effectiveness of controls, you should perform tests of controls. Unlike the evaluation of control design, tests of controls are not required on every audit, only on those audits where the auditor’s risk assessment procedures includes an expectation that the controls will be effective or when substantive procedures alone do not provide sufficient audit evidence at the assertion level.

**Information Technology**

Your understanding of the client and its environment, including its internal control, includes an understanding of how it uses information technology (IT). A client’s use of IT may affect any of the five components of internal control relevant to the achievement of the entity’s financial reporting, operations, compliance objectives, and its operating units or business functions. Examples in which IT affects the entity and its environment are as follows.

- *External factors.* For example, technological innovations may have lowered the barriers to entry into the client’s industry, which in turn increases competition not only for customers, but perhaps also for raw materials or qualified personnel.
• **Client operations.** For example, your client’s manufacturing process may rely more on manual processes and less on technology than its competitors. Consequently, your client’s financial and nonfinancial ratios will differ from others in the industry.

• **Objectives, strategies, and business risks.** For example, your not-for-profit client’s innovative use of technology may allow it to raise contributions from groups of supporters who otherwise would not contribute to the organization.

• **Measurement and review of the client’s financial performance.** For example, management frequently relies on information produced by the company’s IT processing system to measure and review the company’s financial performance. Management’s ability to make decisions appropriately may rely on the accuracy, availability, and timeliness of the information processed by the IT system.

.62 The way in which IT is deployed may vary among entities. For example, your client may use IT as part of discrete systems that support only particular business units, functions, or activities, such as a unique accounts receivable system for a particular business unit or a system that controls the operation of factory equipment. Alternatively, other entities in the same industry may have complex, highly integrated systems that share data and that are used to support all aspects of the company.

**Implications of IT on Your Understanding of Internal Control**

.63 The nature and characteristics of your client’s use of IT in its financial information system affect its internal control. For example:

• Multiple users may access a common database of information. In such circumstances, a lack of control at a single user entry point might compromise the security of the entire database, potentially resulting in improper changes to or destruction of data.

• When IT personnel or users are given, or can gain, access privileges beyond those necessary to perform their assigned duties, a breakdown in segregation of duties can occur. This breakdown could result in unauthorized transactions or changes to programs or data that affect the financial statements.

.64 **General vs. IT Application Controls.** IT general computer controls are polices and procedures that relate to many applications and support the effective functioning and continued proper operation of information systems. For example, your client’s administration of passwords can potentially affect many applications. If passwords for a given user can be stored on that person’s computer, the effectiveness of internal control may be compromised because anyone who gained access to the computer could inappropriately gain access to the application, the related data, or both.

.65 Other IT controls are applied only to specific applications, for example accounts payable, payroll, or the general accounting application. Application controls apply to the processing of individual applications. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and performing manual follow-ups of exception reports.

**How the Client’s Use of IT Affects Audit Planning**

.66 The use of professionals possessing IT skills is a significant aspect of many audit engagements. An IT professional may help:

• Determine the effect of IT on the audit

• Identify and assess IT risks
- Understand IT controls
- Design and perform tests of IT controls or substantive procedures

.67 In determining whether an IT professional is needed on the audit team, you should consider factors such as the following:

- The complexity of the entity’s systems and IT controls and the manner in which they are used in conducting the entity’s business
- The significance of changes made to existing systems, or the implementation of new systems
- The extent to which data is shared among systems
- The extent of the entity’s participation in electronic commerce
- The entity’s use of emerging technologies
- The significance of audit evidence that is available only in electronic form

.68 Audit procedures that you may assign to a professional possessing IT skills include:

- Inquiring of the client’s IT personnel how data and transactions are initiated, authorized, recorded, processed, and reported and how IT controls are designed
- Inspecting systems documentation
- Observing the operation of IT controls
- Planning and performing tests of IT controls

.69 If the use of an IT professional is planned, you should determine whether that professional is effectively functioning as a member of the audit team. If such a professional is part of your audit team, your responsibilities with respect to that professional are equivalent to those for other assistants. In such circumstances, you should have sufficient knowledge of IT matters to:

1. Communicate the objectives of the IT professional’s work
2. Evaluate whether the specified audit procedures will meet your objectives
3. Evaluate the results of the audit procedures applied as they relate to the nature, timing, and extent of further planned audit procedures

Audit Evidence

The Nature of Audit Evidence

.70 Audit evidence is all the information you use to arrive at the conclusions that support your audit opinion. Audit evidence is cumulative in nature. For example, your evidence regarding payables begins with you performing risk assessment procedures relating to the client and its environment, including its internal control. These risk assessment procedures provide audit evidence to support your conclusion about the risk of material misstatement for payables. Based on this risk assessment, you then perform further audit procedures, which include substantive tests and may include tests of controls. The results of these further audit procedures provide audit evidence that, when considered in conjunction with the evidence from risk
assessment procedures, allow you to form a supportable conclusion about payables. You then repeat this process for other accounts, classes of transactions, and disclosures, and the aggregation of your conclusions provides a basis for your opinion on the financial statements taken as a whole.

.71 The procedures that you perform on your audit provide audit evidence, but they are not the only source of audit evidence. For example, previous audits and your firm’s client acceptance and continuance procedures also may be sources of audit evidence.

.72 To determine whether you have obtained persuasive audit evidence, you should consider:

- The consistency of that evidence
- Whether the evidence was obtained from different sources or the performance of procedures that were of a different nature

.73 A lack of consistency among individual items of audit evidence may indicate that one of the items is not reliable. For example, in a not-for-profit entity, the board of trustees' minutes reported that all of the contributions received during the year were unrestricted, but some of the donor agreements examined by you stated that the contributions are temporarily restricted. When audit evidence obtained from one source is inconsistent with that obtained from another, you should determine what additional audit procedures are necessary to resolve the inconsistency.

.74 Ordinarily, you obtain more assurance from consistent audit evidence obtained from different sources or of a different nature than from items of evidence considered individually. For example, reading minutes of the board and other documentation and making inquiries of several individuals about matters included in disclosures usually provide more reliable evidence than does making inquiries of one individual.

The Sufficiency and Appropriateness of Audit Evidence

.75 Sufficiency of Audit Evidence. The sufficiency of audit evidence relates to its quantity. For example, the auditor who tests eight of the twelve monthly reconciliations between a general ledger control account and the related subsidiary ledger will obtain more evidence about the operating effectiveness of the control than the auditor who tests only two of the twelve reconciliations.

.76 The sufficiency of audit evidence you need to support your conclusion is affected by:

- The risk of misstatement. The greater the risk, the more audit evidence likely to be required to support a conclusion
- The quality of the audit evidence obtained. The higher the quality of the evidence, the less that will be required.

.77 Appropriateness of Audit Evidence. The appropriateness of audit evidence relates to its quality. The quality of audit evidence is a function of its relevance and its reliability in providing support, or detecting misstatements, in the accounts, classes of transactions, or assertions.

- Relevance of audit evidence. The results of your audit procedures may provide audit evidence that is relevant to certain assertions but not others. For example, tests of controls related to the proper authorization of a transaction will provide evidence about the occurrence assertion but not about the completeness assertion. Obtaining audit evidence relating to a particular assertion, in this example, the occurrence of a transaction, is not a substitute for obtaining audit evidence regarding another assertion, in this example, completeness.
- Reliability of audit evidence. The reliability of audit evidence is influenced by its source and by its nature. Reliability also depends on the individual circumstances under which it is obtained, including its timing.
Generalizations about the reliability of various kinds of audit evidence can be made; however, when considering such generalizations keep in mind that they are subject to important exceptions. Even when audit evidence is obtained from sources external to the client, circumstances may exist that could affect the reliability of the information obtained. For example, audit evidence obtained from an independent external source may not be reliable if the source is not knowledgeable. While recognizing that exceptions may exist, the following generalizations about the reliability of audit evidence may be useful.

- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence is more reliable when it exists in documentary form (whether paper, electronic, or other medium). For example, minutes of an audit committee meeting are more reliable than a subsequent oral representation of the matters discussed at the meeting.
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.

Typically, you obtain more assurance from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. For example, if the company lacks documentation to support its intent with regard to equity securities (which affect how those securities are classified and presented in the financial statements), you may have no choice but to rely on management’s representations regarding their intent. Management’s representations may be less reliable than a written record, but if you obtain representations from several sources (for example, from different members of management) and these representations are consistent with the client’s past history of selling equity investments, then you may find the consistency of the evidence from different sources to be persuasive.

An increased quantity of audit evidence may compensate for less reliable audit evidence, it cannot compensate for audit evidence that lacks relevancy. For example, a confirmation of an accounts receivable balance is not relevant to the valuation of the allowance account. Increasing the number of receivables confirmations will not provide you with any additional evidence relating to the allowance for doubtful accounts.

Determining Whether You Have Obtained Sufficient, Appropriate Audit Evidence. You may find it necessary to rely on audit evidence that is persuasive rather than conclusive. However, to obtain the reasonable assurance required to support an opinion about the financial statements, you must not be satisfied with audit evidence that is less than persuasive.

Part Three: Applying the Audit Risk Model

This part of the Alert provides a summary of the audit process. Even though some requirements and guidance are presented in a way that suggests a sequential process, audit fieldwork involves a continuous process of gathering, updating, and analyzing information throughout the audit.

The following is an overview of how an auditor should apply the audit risk model in practice.

- Gather information about the entity and its environment, including internal control. Your first step in the process is to gather information about those aspects of the client and its environment that will allow you to identify and assess risks. Evaluating the design of the client’s controls and determining whether they have been implemented are an integral part of this process.
• Understand the entity and its environment, including its internal control. Based on the information
gathered, you should be able to identify what could go wrong in specific relevant assertions related
to each account balance, class of transactions, or disclosures.

• Assess the risk of material misstatement. Next, you will use your understanding of the client and its
environment, including its internal control, to assess the risk of material misstatement that relate to
both financial statement level and specific assertions. To assess risks you will need to:
  — Identify the risk of material misstatement
  — Describe the identified risks in terms of what can go wrong in specific assertions
  — Consider the significance and likelihood of material misstatement for each identified risk

• Design overall responses and further audit procedures. You should address the risk of material misstate-
ment at both the financial statement and the relevant assertion level.
  — The risk of material misstatement at the financial statement level has a more pervasive effect on
the financial statements and affects many assertions. In addition to developing assertion-specific
responses, financial statement-level risks may require you to develop an overall, audit-wide
response, such as assigning more experienced audit team members.
  — Assertion-level risks pertain to a single assertion and should be considered when you design and
subsequently perform further audit procedures. Depending on the results of your risk assessment
procedures, further audit procedures may encompass a combined approach using both tests of
controls and substantive procedures or a substantive audit approach. Either approach is directed
at relevant assertions related to each material account balance, class of transactions, and disclo-
sures. However, regardless of your assessment of risks, you need to perform substantive audit
procedures on all relevant assertions related to each material account balance, class of transaction,
or disclosure.

Information Gathering

Information Needed About the Client and Its Environment to Identify and Assess the Risk
of Material Misstatement

.84 Obtaining an understanding of your client and its environment is an essential part of every audit.
Not only does this understanding allow you to identify and assess the risk of material misstatement, it also
allows you to exercise informed judgment about other audit matters such as:

• Materiality
• Whether the client’s selection and application of accounting policies are appropriate and financial
  statement disclosures are adequate
• Areas where special audit consideration may be necessary, for example, related party transactions
• The expectation of recorded amounts that you develop for performing analytical procedures
• The design and performance of further audit procedures
• The evaluation of audit evidence

.85 Not all information about a client or its environment is relevant for your audit. In general, the
information you should gather about your client is that which allows you to assess the risk that specific
assertions could be materially misstated. The following table summarizes the various categories of informa-
tion you should obtain about your client.
On every audit you are required to gather information and obtain an understanding of the client and its environment. This understanding consists of the following aspects.

- **External factors**, including
  - Industry factors such as the competitive environment, supplier and customer relationships, and technological developments.
  - The regulatory environment, which includes relevant accounting pronouncements, the legal and political environment, and environmental requirements that affect the industry.
  - Other matters such as general economic conditions.

- **Nature of the client**, which includes its operations, its ownership, governance, the types of investments it makes and plans to make, how it is financed, and how it is structured.

- **Objectives and strategies and related business risks**, which may result in material misstatement of the financial statements taken as a whole or individual assertions.

- **Measurement and review of the client’s financial performance**, which tells you which aspects of the client’s performance that management considers to be important.

- **Internal control**, which consists of five components: the control environment, risk assessment, information and communication, control activities, and monitoring. These components may operate at the entity level or the individual transaction level. To obtain an appropriate understanding of internal control will require you to understand and evaluate the design of all five components of internal control and to determine whether the controls are in use by the client.

### Risk Assessment Procedures

.86 The audit procedures you perform to obtain an understanding of the entity and its internal control are referred to as *risk assessment procedures*. Some of the information you obtain by performing risk assessment procedures you will use to support your assessments of the risks of material misstatement. Risk assessment procedures include:

1. Inquiries of management and others at the client
2. Analytical procedures
3. Observation and inspection

.87 You need to gather audit evidence to support your assessment of the risk of material misstatement. It is not acceptable to simply deem control risk to be “at the maximum” without support. Your risk assessment procedures provide the audit evidence necessary to support your risk assessments, which in turn, support your determination of the nature, timing, and extent of further audit procedures. Thus, the results of your risk assessment procedures are an integral part of the audit evidence you obtain to support your opinion on the financial statements.

.88 *A Mix of Procedures*. Except for internal control, you are not required to perform all the procedures for each of the five aspects of the client and its environment discussed previously. However, in the course of gathering information about the client, you should perform all the risk assessment procedures.

.89 With regard to obtaining an understanding about the design of internal control and determining whether they have been implemented, inquiry alone is not sufficient. Thus, for these purposes, you should supplement your inquiries with other risk assessment procedures.
.90 Other Procedures That Provide Relevant Information About the Client. Following include some procedures you might consider.

- Assessing the Risk of Material Misstatement Due to Fraud. AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), directs you to perform certain audit procedures to assess the risk of material misstatement due to fraud. Some of these procedures also may help gather information about the entity and its environment, particularly its internal control. For this reason, you should:
  - Coordinate the procedures you perform to assess the risk of material misstatement due to fraud with your other risk assessment procedures
  - Consider the results of your assessment of fraud risk when identifying the risk of material misstatement

- Other Information. When relevant to the audit, you also should consider other knowledge you have of the client that can help you assess risk. This other information may include:
  - Information obtained from your client acceptance or continuance process
  - Experience gained on other engagements performed for the entity

.91 Updating Information From Prior Periods. If certain conditions are met, you may use information about the client you obtained in prior periods as audit evidence in the current period audit. However, when you intend to use information from prior periods in the current period audit, you should determine whether changes have occurred that may affect the relevance of the information for the current audit. To make this determination, you should make inquiries and perform other appropriate audit procedures, such as walkthroughs of systems.

Gaining an Understanding of the Client and Its Environment

.92 The gathering of information, by itself, does not provide you with the understanding of the client that is necessary for you to assess risk. For you to assess the risk of material misstatement and perform further audit procedures, you need to synthesize the information gathered to determine how it might affect the financial statements. For example:

- Information about the client’s industry may allow you to identify characteristics of the industry that could give rise to specific misstatements. For example, if your client is a construction contractor that uses long-term contract accounting, your understanding of the client should be sufficient to allow you to recognize that the significant estimates of revenues and costs create a risk of material misstatement.

- Information about the ownership of your client, how it is structured, and other elements of its nature will help you identify related party transactions that, if not properly accounted for and adequately disclosed, could lead to a material misstatement.

- Your identification and understanding of the business risks facing your client increase the chance that you will identify financial reporting risks. For example, your client may face a risk that a new company may enter its market, and that new entrant could have certain business advantages (for example, economies of scale or greater brand recognition). The potential risk of material misstatement of the financial statements related to this business risk might be obsolescence or overproduction of inventory that could only be sold at a discount.

- Information about the performance measures used by client management may lead you to identify pressures or incentives that could motivate client personnel to misstate the financial statements.

- Information about the design and implementation of internal control may lead you to identify deficiencies in control design, which increase the risk of material misstatement.


Evaluating the Design of Internal Control

.93 A sufficient understanding of internal control is one that allows you to evaluate the design of internal control and to determine whether controls have been placed in operation. This threshold describes a substantial understanding of internal control.

Requirements for Evaluating Control Design

.94 On every audit, you should obtain an understanding of internal control that is of sufficient depth to enable you to:

1. Assess the risks of material misstatement of the financial statements, whether due to error or fraud
2. Design the nature, timing, and extent of further audit procedures

.95 To meet this threshold of sufficiency, at both the entity and relevant assertion level, you should:

1. Evaluate the design of controls that are relevant to the audit and determine whether the control—either individually or in combination—is capable of effectively preventing or detecting and correcting material misstatements.
2. Determine that the control has been implemented, that is, that the control exists and that the entity is using it.

.96 Your evaluation of internal control design and the determination of whether controls have been implemented are critical to your assessment of the risks of material misstatement. It is not possible to develop a reliable assessment of the risk of material misstatement absent a sufficient understanding of internal control. For this reason, you are required to perform risk assessment procedures to gather information and form an understanding of internal control on every audit. Even if your initial audit strategy contemplates performing only substantive procedures for all relevant assertions related to material transactions, account balances, and disclosures, you still need to evaluate the design of your client’s internal control.

.97 How to Evaluate Control Design. In evaluating control design, it is helpful to consider:

- Whether control objectives that are specific to the unique circumstances of the client have been considered for all relevant assertions for all significant accounts and disclosures

- Whether the control or combination of controls would—if operated as designed—meet the control objective

- Whether all controls necessary to meet the control objective are in place

Determining If the Control Has Been Implemented

.98 It may be possible that the way in which a control is applied by an entity differs from the description of the control in a policy manual or from one individual’s understanding of how the control is applied. For example, your client’s accounting policy manual may state that physical inventory accounts are performed annually. However, because of increases in the volume of transactions, the client deviates from this stated policy and counts some inventory items twice a year. This practice is not reflected in the policy manual and is not known by all individuals in the company. Determining whether a control has been implemented is important because it confirms your understanding of control design.

.99 The determination of whether a control has been put in place and is in use involves obtaining evidence about whether those individuals responsible for performing the prescribed procedures have:
• An awareness of the existence of the procedure and their responsibility for its performance
• A working knowledge of how the procedure should be performed

.100 Determining whether the control has been implemented does not require you to determine whether the control was performed properly throughout the audit period.

.101 Distinguishing Between Evaluation of Design and Tests of Controls. Obtaining an understanding of the design and implementation of internal control is different from testing its operating effectiveness.

• Understanding design and implementation is required on every audit as part of the process of assessing the risks of material misstatement.
• Testing the operating effectiveness builds on your understanding of internal control design and implementation and is necessary only where the auditor’s risk assessment procedures include an expectation that the controls will be effective or when substantive procedures alone do not provide you with sufficient audit evidence at the assertion level.

.102 The procedures necessary to understand the design and implementation of controls do provide some limited evidence regarding the operation of the control.2

.103 However, the procedures necessary to understand the design and implementation of controls generally are not sufficient to serve as a test of their operating effectiveness for the purpose of placing significant reliance on their operation. For example, obtaining audit evidence about the implementation of a manually operated control at a point in time does not provide audit evidence about the operating effectiveness of control at other times during the period under audit.

.104 Examples of situations where the procedures you perform to understand the design and implementation of controls may provide sufficient audit evidence about their operating effectiveness include:

• Controls that are automated to the degree that they can be performed consistently provided that IT general controls over those automated controls operated effectively during the period.
• Controls that operate only at a point in time rather than continuously throughout the period. For example, if the client performs an annual physical inventory count, your observation of that count and other procedures to evaluate its design and implementation provide you with evidence that you consider in the design of your substantive procedures.

.105 Evaluating Design and Implementation in the Absence of Control Documentation. For smaller companies, the company’s evidence supporting the design and implementation of some elements of internal control may not be available in documentary form. For example, the entity may lack:

• A written code of conduct that describes management’s commitment to ethical values
• A formal risk assessment process

.106 Without adequate documentation of controls, the risk assessment procedures available to you to understand control design are limited to inquiry and observation. As risk assessment procedures, both inquiry and observation have limitations, and accordingly, absent adequate documentation, you should consider whether the information you have gathered about internal control is sufficient to evaluate its design.

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2 For example, a walkthrough that traces a transaction from its inception through its recording is considered a test of one transaction. Examination of several documents evidencing the operation of a control at a key control point may also be considered as a test. Generally, the evidence required to rely on the operation of the control will be greater than that required to simply assess whether it has been placed in operation.
Inadequate documentation of the components of internal control also may be a control deficiency. For example, the lack of appropriate documentation may impair management’s ability to communicate control procedures to those responsible for their performance or to monitor control performance effectively.

**Discussion Among the Audit Team**

The members of the audit team should discuss the susceptibility of the client’s financial statements to material misstatement. This discussion will allow team members to exchange information and create a shared understanding of the client and its environment, which in turn will enable each team member to:

- Gain a better understanding of the potential for material misstatement resulting from fraud or error in the assertions that are relevant to the areas assigned to them
- Understand how the results of the audit procedures that they perform may affect other aspects of the audit.

This discussion among the audit team could be held at the same time as the discussion among the team related to fraud, which is required by AU section 316.

**Assessing the Risk of Material Misstatement**

**Considerations at the Financial Statement Level**

You should use your understanding of the client and its environment—which includes your evaluation of the design and implementation of internal control—to assess the risk of material misstatement. To make this assessment, you should:

1. Identify risks throughout the process of obtaining an understanding of the entity, its internal control, and its environment.
2. Relate the identified risks to what can go wrong at the relevant assertion level.
3. Consider whether the risks could result in a material misstatement to the financial statements.
4. Consider the likelihood that the risks could result in a material misstatement of the financial statements.

**Financial Statement-Level and Assertion-Level Risks.** You should identify and assess the risks of material misstatement at both the financial statement level and the relevant assertion level.

1. **Financial statement-level risks.** Some risks of material misstatement relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. These risks at the financial statement level may be identifiable with specific assertions at the class of transaction, account balance, or disclosure level.

2. **Relevant assertion-level risks.** Other risks of material misstatement relate to specific classes of transactions, account balances, and disclosures at the assertion level. Your assessment of risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures.

Risks that exist at the financial statement level, for example, those that pertain to a weak control environment or to management’s process for making significant accounting estimates, should be related to specific assertions. For example, risks related to the client’s process for making accounting estimates would affect those assertions where an accounting estimate was necessary (for example, the valuation of assets).
In other instances, it may not be possible for you to relate your financial statement-level risks to a particular assertion or group of assertions. For example, it may not be possible for you to determine which assertions will or will not be affected by a weak control environment. Financial statement-level assertions that can not be related to specific assertions will require you to make an overall response, such as the way in which the audit is staffed or supervised.

How to Consider Internal Control When Assessing Risks. Your evaluation of internal control design and the determination of whether controls have been implemented are integral components of the risk assessment process. When making risk assessments, you should identify the controls that are likely to either prevent or detect and correct material misstatements in specific assertions. For example, procedures relating to the client’s physical inventory count may relate specifically to the existence or completeness of inventory.

Individual controls often do not address a risk completely in themselves. Often, only multiple control activities, together with other components of internal control (for example, the control environment, risk assessment, information and communication, or monitoring), will be sufficient to address a risk. For this reason, when determining whether identified controls are likely to prevent or detect and correct material misstatements, you generally organize your risk assessment procedures according to significant transactions and accounting processes (for example, sales, cash receipts, or payroll), rather than general ledger accounts.

Identification of Significant Risks. As part of your risk assessment, you should identify significant risks, which are defined as those risks that require special audit consideration. For example, if your client is named as a defendant in a patent infringement lawsuit that may threaten the viability of its principal product, you could consider as significant risks, the risks that the lawsuit (1) would not be appropriately recorded or disclosed in accordance with generally accepted accounting principles or (2) may affect the entity’s ability to continue as a going concern.

Significant risks arise on most audits. When you determine that a risk is a significant risk, your audit procedures should include (but not be limited to):

- Obtaining an understanding of internal control, including relevant control activities, related specifically to those significant risks.
- If you plan to rely on the operating effectiveness of controls related to significant risks, testing the operating effectiveness of those controls in the current period. That is, using evidence about operating effectiveness that you obtained in prior periods is not appropriate.
- Substantive procedures specifically designed to address the significant risk.

Significant risks should be distinguished from transactions or events that have a high inherent risk, which could be mitigated by the client’s internal controls. For example, because of the nature of your client and the industry in which it operates, you might assess a high inherent risk on revenue recognition. However, the client may have controls over revenue recognition; you would then obtain an understanding of such controls and determine whether they are implemented and, if appropriate, test their operating effectiveness. This circumstance may not warrant special audit consideration and thus may not be a significant risk.

The determination of whether a transaction or event is a significant risk is a matter for your professional judgment.

Considerations at the Assertion Level

Part Two of this Alert provides a definition of audit risk (AR) in which:

AR = RMM x DR

where RMM is the risk of material misstatement and DR is detection risk
The risk of material misstatement is described as “the entity’s risk,” which means that it is independent of your audit. You can control detection risk by changing the nature, timing, and extent of your audit procedures. For example, to decrease the planned level of detection risk, you could perform more extensive substantive tests.

.120 You cannot control the risk of material misstatement as you can detection risk because RMM exists independently from your audit procedures. However, to properly gauge the detection risk you are willing to accept, you need to assess the risks of material misstatement. The risk assessment process described in the SASs is designed to allow you to gather information and assess the risks of material misstatement so you can design further audit procedures that reduce audit risk to an acceptably low level.

Determining Materiality and Tolerable Misstatement

.121 You should determine a materiality level for the financial statements taken as a whole when establishing the overall audit strategy for the audit. The determination of materiality will assist you in (1) making judgments when identifying and assessing the risk of material misstatement and (2) determining the nature, timing, and extent of your further audit procedures. In determining financial statement materiality, you will often apply percentages to benchmarks. The determination of materiality, including the selection of the appropriate benchmark and percentages, is a matter of your professional judgment and depends on the nature and circumstances of your audit.

.122 In addition to the quantitative considerations, you should be alert for misstatements that could be qualitatively material, for example, misstatements that may change a loss into income or vice versa, may potentially affect loan covenants, or may increase management’s compensation.

.123 After you determine the financial statement materiality, you should set a tolerable misstatement, which is the adjustment of the financial statement materiality to the assertion level. Tolerable misstatement will assist you in assessing the risk of material misstatement and in designing and performing further audit procedures.

.124 Because the entity’s circumstances may change as the audit progresses, you should reassess the financial statement materiality and tolerable misstatement levels initially determined. Failure to do so may result in you failing to obtain sufficient audit evidence to support your opinion.

Responding to Assessed Risks

Linking Assessed Risks to Further Audit Procedures

.125 The risk assessment process culminates with your articulation of the account balances, classes of transactions, or disclosures where material misstatements are most likely to occur. This assessment of risk relates identified risks to what can go wrong at the assertion level and the way in which misstatements are likely to occur. Your risk assessment provides the basis for designing and performing further audit procedures.

.126 You can think of your assessment of risks as having two dimensions: direction and amplitude. Direction relates to where misstatements can occur, that is, the specific assertions related to an account, class of transactions, or disclosure. Amplitude relates to the possible magnitude of the misstatement that could occur. Magnitude is a function of two variables: the potential significance of the misstatement (for example, whether it is material) and the likelihood of a misstatement occurring (for example, remote, likely). Your evaluation of the design and implementation of internal control affects all elements of your risk assessment process.
Further Audit Procedures

.127 You perform further audit procedures to obtain the audit evidence necessary to support your audit opinion. Further audit procedures consist of either tests of controls or substantive tests. Often, a combined approach using both tests of controls and substantive procedures is an effective approach. You are not precluded from adapting a substantive audit approach provided that you have and document an appropriate basis for this approach.

.128 In determining the nature, timing, and extent of further audit procedures, you should design and perform further procedures whose nature, timing, and extent are responsive to the assessed risk of material misstatement at the relevant assertion level. You should provide and document a clear linkage between your assessment of the risk of material misstatement and the nature, timing, and extent of the further audit procedures.

.129 Audit procedures performed in previous audits and example procedures provided by illustrative audit programs may help you understand the types of further audit procedures that are possible for you to perform. However, prior year procedures and example audit programs do not provide a sufficient basis for determining the nature, timing, and extent of audit procedures to perform in the current audit. Your assessment of the risk of material misstatement in the current period is the primary basis for designing further audit procedures in the current period.

Evaluating Audit Findings

.130 In evaluating whether the financial statements are presented fairly, you must consider the effects, both individually and in the aggregate, of misstatements (known and likely) identified by you that are not corrected by the client.

.131 Your consideration and aggregation of misstatements should include both of the following:

- Known misstatements, which are the amount of misstatements specifically identified
- Likely misstatements, which include (1) projected misstatements in the account balances or classes of transactions that you have examined and (2) differences between management's and the auditor's judgments concerning accounting estimates that the auditor considers unreasonable or inappropriate.

.132 Misstatements should be aggregated in a way that enables the auditor to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole.

.133 Before considering the aggregate effect of identified uncorrected misstatements, the auditor should consider each misstatement separately to evaluate:

1. Its effect in relation to the relevant individual classes of transactions, account balances, or disclosures, including qualitative considerations.
2. Whether, in considering the effect of the individual misstatement on the financial statements taken as a whole, it is appropriate to offset misstatements. For example, it may be appropriate to offset misstatements of items within the same account balance in the financial statements.
3. The effect of misstatements related to prior periods. In prior periods, misstatements may not have been corrected by the entity because they did not cause the financial statements for those periods to be materially misstated. Those misstatements might also affect the current period's financial statements.
.134 In aggregating misstatements, you should include the effect on the current period’s financial statements of those prior period misstatements. When evaluating the aggregate uncorrected misstatements, you should consider the effects of these uncorrected misstatements in determining whether the financial statements are free of material misstatement.

.135 There are quantitative and qualitative materiality considerations, and you should consider both when evaluating audit results. Because of qualitative considerations, misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

Evaluating Whether the Financial Statements Taken as a Whole Are Free of Material Misstatement

.136 You must evaluate whether the financial statements taken as a whole are free of material misstatement. In making this evaluation, you should consider the evaluation of the uncorrected (known and likely) misstatements you identified during the audit. When concluding about whether the effect of misstatements, individually or in the aggregate, is material, you should consider the nature and amount of the misstatements in relation to the nature and amount of items in the financial statements under audit. For example, an amount that is material to the financial statements of one entity may not be material to the financial statements of another entity of a different size or nature. Also, what is material to the financial statements of a particular entity might change from one period to another.

.137 If you believe that the financial statements taken as a whole are materially misstated, you should request management to make the necessary corrections. If management refuses to make the corrections, you must determine the implications for the auditor’s report.

.138 If you conclude that the effects of uncorrected misstatements are not material, you should consider that the financial statements themselves could still be materially misstated because of additional misstatements that you did not detect. As the aggregate misstatements approach materiality, the risk that the financial statements may be materially misstated also increases. Accordingly, you should consider the effect of undetected misstatements in concluding whether the financial statements are fairly stated.

The Iterative Nature of Auditing

.139 An audit of financial statements is a cumulative and iterative process. As you perform planned audit procedures—whether they be risk assessment procedures, substantive tests, or tests of controls—the audit evidence you obtain may cause you to modify the nature, timing, or extent of other planned audit procedures. Information may come to your attention that differs significantly from the information on which the risk assessments were based.

.140 For example, the extent of misstatements that you detect by performing substantive procedures may alter your judgment about the risk assessments and may indicate a material weakness in internal control. Or, analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognized risk of material misstatement. In such circumstances, you should reevaluate the planned audit procedures based on the revised consideration of assessed risks.

Audit Documentation

General Documentation Requirements

.141 In general, you should document certain matters pertaining to each step in the risk assessment process. This audit documentation should provide a clear understanding of the work performed, the source of the information, and the conclusions reached.
.142 The form and content of audit documentation are for you to determine using professional judgment. AU section 339, Audit Documentation (AICPA, Professional Standards, vol. 1), provides general guidance regarding the purpose, content, ownership, and confidentiality of audit documentation. Examples of common documentation techniques include narrative descriptions, questionnaires, checklists, and flowcharts. These techniques may be used alone or in combination.

.143 The form and extent of your documentation are influenced by the following:

- The nature, size, and complexity of the entity and its environment
- The availability of information from the entity
- The specific audit methodology and technology used in the course of the audit

.144 For example, documentation of the understanding of a complex information system in which a large volume of transactions are electronically initiated, authorized, recorded, processed, or reported may include flowcharts, questionnaires, or decision tables. For an information system making limited or no use of IT or for which few transactions are processed, documentation in the form of a memorandum may be sufficient. Generally, the more complex the entity and its environment, and the more extensive the audit procedures performed by the auditor, the more extensive your documentation should be. The specific audit methodology and technology used in the course of the audit will also affect the form and extent of documentation.

Specific Documentation Requirements

.145 The SASs require you to document the following matters.

- The levels of materiality and tolerable misstatement, including any changes thereto, used in the audit and the basis on which those levels were determined.
- The discussion among the audit team regarding the susceptibility of the entity’s financial statements to material misstatement due to error or fraud, including how and when the discussion occurred, the subject matter discussed, the audit team members who participated, and significant decisions reached concerning planned responses at the financial statement and relevant assertion levels.
- Key elements of the understanding obtained regarding each of the aspects of the entity and its environment, including each of the components of internal control, to assess the risks of material misstatement of the financial statements, the sources of information from which the understanding was obtained, and the risk assessment procedures.
- The assessment of the risks of material misstatement both at the financial statement level and at the relevant assertion level and the basis for the assessment.
- The significant risks identified and related controls evaluated.
- The overall responses to address the assessed risks of misstatement at the financial statement level.
- The nature, timing, and extent of the further audit procedures.
- The linkage of those procedures with the assessed risks at the relevant assertion level.
- The results of the audit procedures.
- The conclusions reached with regard to the use in the current audit of audit evidence about the operating effectiveness of controls that was obtained in a prior audit.
- A summary of uncorrected misstatements, other than those that are trivial, related to known and likely misstatements.
- Your conclusion about whether uncorrected misstatements, individually or in aggregate, do or do not cause the financial statements to be materially misstated, and the basis for that conclusion.
Uncorrected misstatements should be documented in a manner that allows the auditor to:

- Separately consider the effects of known and likely misstatements, including uncorrected misstatements identified in prior periods.
- Consider the aggregate effect of misstatements on the financial statements.
- Consider the qualitative factors that are relevant to the auditor’s consideration of whether misstatements are material.

**Resource Central**

The AICPA will offer continuing professional education courses, including a self-study course as well as a group study course. In addition, the new risk assessment standards will be a topic of discussion in various AICPA conferences in which AICPA presenters will further explain the standards.

**On the Bookshelf**

**Future AICPA Audit Guide on Risk Assessment and Internal Control**

The AICPA is currently developing an Audit Guide to aid in implementing the new risk assessment standards. In addition, the AICPA is revamping its existing Audit Guide titled *Consideration of Internal Control in a Financial Statement Audit*. The current development plan envisions combining these two guides into one audit guide. This audit guide should be available by mid-2006 and can be purchased by contacting the AICPA/CPA2Biz Service Center at (888) 777-7077 or online at www.cpa2biz.com.

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.153 Members of the AICPA’s Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

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AICPA Online and CPA2Biz

.154 AICPA Online (www.aicpa.org) offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, www.cpa2biz.com offers all the latest AICPA products, including the Audit and Accounting Guides, Professional Standards, CPE courses, Practice Aids, and Audit Risk Alerts.

.155 Any comments that you have about this Alert may be e-mailed to lpombo@aicpa.org or mailed to:

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[The next page is 9000-251.]
AAM Section 8300

Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115

COMPANION TO SAS NO. 115, COMMUNICATING INTERNAL CONTROL RELATED MATTERS IDENTIFIED IN AN AUDIT

Notice to Readers

This Audit Risk Alert is intended to help auditors understand and implement the requirements of Statement on Auditing Standards (SAS) No. 115, Communicating Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, vol. 1, AU sec. 325), which supersedes SAS No. 112 of the same name.

This publication is an other auditing publication as defined in AU section 150, Generally Accepted Auditing Standards. Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Technical Manager
Accounting and Auditing Publications

Introduction

.01 In October 2008, the AICPA Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 115, Communicating Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, vol. 1, AU sec. 325). SAS No. 115 amends SAS No. 112 and further clarifies standards and provides guidance on communicating matters related to an entity’s internal control over financial reporting (internal control) identified in an audit of financial statements.

.02 The new SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) except when the auditor is performing an integrated audit and will be expressing an opinion on the effectiveness of internal control over financial reporting under AT section 501 (AICPA, Professional Standards, vol. 1). This new standard is effective for audits of financial statements for periods ending on or after December 15, 2009. This Audit Risk Alert provides an overview of the requirements of SAS No. 115 as well as case studies that illustrate how deficiencies in internal control may be evaluated for severity.

Why SAS No. 115 Was Issued

.03 The Sarbanes-Oxley Act of 2002 and the issuance of Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements, which has since been superseded by PCAOB Auditing
Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”), created considerable interest in management’s responsibility for internal control and the auditor’s responsibility for bringing certain internal control related matters to management’s attention in an audit of financial statements. This renewed interest in an auditor’s responsibility to report internal control deficiencies identified in an audit in conjunction with the goal of the ASB to converge definitions with Auditing Standard No. 2 led the ASB to issue SAS No. 112. By issuing SAS No. 115, the ASB revised SAS No. 112 maintain the uniformity of the definitions of the various kinds of deficiencies in internal control and the related guidance for evaluating such deficiencies with the definitions and guidance in Auditing Standard No. 5.

Overview of the Standard

.04 In general, SAS No. 115 retains many of the provisions of SAS No. 112; it provides guidance to enhance the auditor’s ability to identify and evaluate deficiencies in internal control during an audit, and then communicate to management and those charged with governance those deficiencies that the auditor believes are significant deficiencies or material weaknesses.

.05 The key differences between SAS No. 115 and SAS No. 112 lie in the definitions of material weaknesses and significant deficiencies and the process for making that determination. Under SAS No. 112, the auditor applied criteria of likelihood and magnitude described in that standard to determine if a control deficiency reached the threshold of significant deficiency or material weakness. Under SAS No. 115, the same criteria are used; however, more judgment is allowed for in determining whether a control deficiency is a significant deficiency.

Identifying Deficiencies in Internal Control

.06 A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis:
  
  - A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if it operates as designed, the control objective would not be met.
  - A deficiency in operation exists when (a) a properly designed control does not operate as designed or (b) when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

The Auditor’s Responsibility for Identifying Deficiencies in Internal Control

.07 When conducting an audit of financial statements, the auditor is not required to perform procedures to identify deficiencies in internal control. However, during the course of the audit, the auditor may become aware of deficiencies in the design or operation of the entity’s internal control. The auditor may identify deficiencies in internal control at any point in the audit, for example, while
  
  - obtaining an understanding of the entity and its environment, including its internal control,
  - assessing the risks of material misstatement of the financial statements, due to error or fraud,
  - performing further audit procedures to respond to assessed risks, or
  - communicating with management or others (for example, internal auditors or governmental authorities).

.08 The awareness of deficiencies in internal control will vary with each audit and will be influenced by the nature, timing, and extent of audit procedures performed, as well as other factors. The results of substantive procedures may result in the need to reevaluate the earlier assessment of internal control.
Evaluating Deficiencies in Internal Control

A deficiency in internal control may be considered just a deficiency. More severe deficiencies are significant deficiencies, and the most severe deficiencies are material weaknesses.

Definitions of Significant Deficiency and Material Weakness

A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis. For the purpose of this definition, a reasonable possibility exists when the likelihood of the event is either reasonably possible or probable as those terms are used in Financial Accounting Standards Board (FASB) Statement No. 5, Accounting for Contingencies.1 2

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

The Evaluation Process

The auditor should evaluate the severity of each deficiency in internal control identified during the audit and determine whether the deficiency, individually or in combination with other deficiencies in internal control, rise to the level of significant deficiencies or material weaknesses. The severity of a deficiency in internal control depends on

- the magnitude of the potential misstatement resulting from the deficiency or deficiencies; and
- whether there is a reasonable possibility that the entity’s controls will fail to prevent or to detect and correct a misstatement of an account balance or disclosure.

The severity of a deficiency does not depend on whether a misstatement actually occurred. If the auditor identifies a deficiency in internal control but has not identified an actual misstatement related to that deficiency, the auditor cannot automatically conclude that the deficiency is not a significant deficiency or a material weakness. If a misstatement has been identified, the auditor should consider the potential for further misstatement in the financial statements being audited.

Magnitude

Magnitude refers to the extent of the misstatement that could have occurred, or that actually occurred, because misstatements include both potential and actual misstatements. In evaluating the magnitude of the potential misstatement, the maximum amount by which an account balance or total of transactions can be overstated generally is the recorded amount, whereas understatements could be larger. For example, if a control deficiency exists over the completeness of accounts payable, and the recorded amount is $200,000, the most the amount could be overstated is $200,000. But the most the amount could be understated cannot be known.

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1 The term reasonable possibility as used in the definitions of the term material weakness has the same meaning as defined in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, Accounting for Contingencies. Paragraph 3 of FASB Statement No. 5 states:

When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This statement uses the terms probable, reasonably possible, and remote to identify three areas within that range, as follows:

a. Probable. The future event or events are likely to occur.
b. Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.
c. Remote. The chance of the future event or events occurring is slight.

Therefore, the likelihood of an event is a reasonable possibility when it is reasonably possible or probable.

2 At the time of this writing, the FASB Accounting Standards Codification (ASC) had not yet been issued as authoritative. When the FASB ASC is issued as authoritative, the definitions currently found in FASB Statement No. 5 will be located at FASB ASC 450-20-25-1.
Factors that affect the magnitude of a misstatement that might result from a deficiency or deficiencies include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency
- The volume of activity (in the current period or expected in future periods) in the account or class of transactions exposed to the deficiency

**Probability of Occurrence**

Probability of occurrence refers to the likelihood that a control, or combination of controls, could have failed to prevent or detect a misstatement in the financial statements being audited. The evaluation of whether a deficiency presents a reasonable possibility of misstatement may be made without quantifying the probability of occurrence as a specific percentage or range. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

Risk factors affect whether a reasonable possibility exists that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following:

- The nature of the financial statement accounts, classes of transactions, disclosures, and assertions involved
- The susceptibility of the related asset or liability to loss or fraud
- The subjectivity, complexity, or extent of judgment required to determine the amount involved
- The interaction or relationship of the control with other controls
- The interaction among the deficiencies
- The possible future consequences of the deficiency

The following table summarizes the consideration of the severity of a deficiency to determine whether it is a deficiency in internal control, a significant deficiency, or a material weakness.

<table>
<thead>
<tr>
<th>Magnitude of misstatement that occurred, or could have occurred</th>
<th>Probability of misstatement</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reasonably Possible</td>
</tr>
<tr>
<td>Quantitatively or qualitatively material</td>
<td>Material weakness</td>
</tr>
<tr>
<td>Less than material</td>
<td>Deficiency in internal control that could be a significant deficiency but not a material weakness</td>
</tr>
</tbody>
</table>

As shown in the preceding table, a deficiency in internal control that is less than material, less than reasonably possible, or both, could be considered a significant deficiency if it is determined by the auditor’s professional judgment to merit the attention of those charged with governance.

The following are examples of deficiencies in internal control and how their magnitude and probability of occurrence might be considered:

- A deficiency in controls over revenue transactions that results in a financial statement misstatement. In this case, the auditor assesses the probability of a control preventing or detecting and correcting the misstatement.
Because the misstatement actually occurred, the auditor assesses the probability as reasonably possible. The auditor then considers the potential magnitude of the misstatement. If the amounts are greater than materiality, the control deficiency would be classified as a material weakness. If the amounts are less than material, the auditor would apply his or her professional judgment as to whether this deficiency is important enough to merit the attention of those charged with governance.

- **Failure to obtain required authorization for a valid disbursement.** In this situation, the auditor again assesses the probability of the control failing and the magnitude of the misstatement that could result from recording an unauthorized disbursement, using the factors listed previously.

**Multiple Deficiencies in Internal Control**

.21 Multiple deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control increase the likelihood of material misstatement and may, in combination, constitute a significant deficiency or a material weakness, even though such deficiencies individually may be less severe. Therefore, the auditor should determine whether deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a significant deficiency or a material weakness.

**Mitigating Effects of Compensating Controls**

.22 When a deficiency in internal control has been identified, management may inform the auditor, or the auditor may otherwise become aware of the existence of compensating controls that, if effective, may limit the severity of the deficiency in internal control and prevent it from being a significant deficiency or material weakness. In these circumstances, although the auditor is not required to consider the effects of compensating controls for purposes of this standard, the auditor may rely on the operating effectiveness of compensating controls related to a deficiency in operation provided the auditor has tested the compensating controls for operating effectiveness as part of the financial statement audit. Compensating controls can limit the severity of the deficiency, but they do not eliminate the deficiency.

.23 For example, consider a situation in which there is a lack of segregation of duties within the accounts payable function in an owner-managed entity. As a compensating control, the owner reviews the supporting documentation for all disbursements exceeding $1,000. As part of the audit, the auditor could test this compensating control and determine whether it operates effectively for the purpose of mitigating the effects of the deficiency in internal control (lack of segregation of duties) in the accounts payable function. Although the deficiency in internal control still exists—the review does not eliminate the lack of segregation of duties—the significance of the deficiency may be mitigated by the compensating control so that it is not a significant deficiency or a material weakness.

**The Prudent Official Test**

.24 If the auditor determines that a deficiency, or a combination of deficiencies, is not a material weakness, the auditor should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion. Although the term **prudent official** is not defined in the standard, the concept is that an auditor should “stand back” and take another objective look at the severity of the deficiency as would a regulator or someone from an oversight agency. The auditor should consider whether a **prudent official** (having the auditor’s knowledge about the facts and circumstances, the magnitude and probability of occurrence of the potential misstatement, and the other controls that were tested) would agree with the auditor’s conclusion that a deficiency is not a material weakness. Because a prudent official is cautious, the prudent official test is used only to increase the severity of a deficiency in internal control and not to justify a decrease in the severity.
Communication Requirements

Form of Communication

.25 The auditor should communicate in writing to management and those charged with governance.

Content of Communication

.26 Deficiencies identified during the audit that upon evaluation are considered significant deficiencies or material weaknesses under this section should be communicated, in writing, to management and those charged with governance as a part of each audit, including significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits and have not yet been remediated. Significant deficiencies and material weaknesses that previously were communicated and have not yet been remediated may be communicated, in writing, by referring to the previously issued written communication and the date of that communication.

.27 The written communication regarding significant deficiencies and material weaknesses identified during the audit of financial statements should include

- a statement that indicates the purpose of the auditor’s consideration of internal control was to express an opinion on the financial statements, but not to express an opinion on the effectiveness of the entity’s internal control.
- a statement that indicates the auditor is not expressing an opinion on the effectiveness of internal control.
- a statement that indicates that the auditor’s consideration of internal control was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.
- the definition of the term material weakness and, where relevant, the definition of the term significant deficiency.
- identification of the matters that are considered to be significant deficiencies and those that are considered to be material weaknesses.
- a statement that indicates the communication is intended solely for the information and use of management, those charged with governance, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties. If an entity is required to furnish such auditor communications to a governmental authority, specific reference to such governmental authorities may be made.

.28 The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit. Such a communication could be misinterpreted as providing a higher level of assurance than it actually represents.

.29 Paragraph .28 of SAS No. 115 contains an illustrative communication that encompasses the requirements of the standard. In addition, SAS No. 115 contains an illustrative communication that may be used when the auditor has been requested to advise management and those charged with governance of the fact that no material weaknesses were identified. Also illustrated is a paragraph to be added to the auditor’s communication when, for the benefit of a regulator, management’s response to the auditor’s communication of significant deficiencies and material weaknesses is included in a document with the auditor’s written communication.

Communicating Other Matters

.30 Nothing in SAS No. 115 precludes the auditor from communicating to management and those charged with governance other matters related to an entity’s internal control. For example, the auditor may
communicate matters the auditor believes to be of potential benefit to the entity, such as recommendations for operational or administrative efficiency, or for improving controls. The auditor may also communicate deficiencies that are not significant deficiencies or material weaknesses. When other matters are communicated orally, the auditor should document the communication.

**Timing of Communication**

.31 Best practice is to issue the written communication by the report release date. The auditor should issue the written communication no later than 60 days following the report release date.

.32 For some matters, early communication to management or those charged with governance may be important because of their relative significance and the urgency for corrective follow-up action. Accordingly, the auditor may decide to communicate certain matters during the audit. These matters need not be communicated in writing during the audit, but significant deficiencies and material weaknesses should ultimately be included in a written communication even if such significant deficiencies or material weaknesses were remediated during the audit.

**How the Revisions Will Affect Practice**

.33 As the auditor gains a better understanding of the entity’s system of internal control over financial reporting, he or she may identify more deficiencies in internal control that are

- identified as significant deficiencies and material weaknesses, and
- communicated to management and those charged with governance.

**Discussions With Management and Others**

.34 The requirements of SAS No. 112 and now SAS No. 115 may change perceptions of the auditor’s role in the client’s internal control. The auditor may have to explain to clients that the auditor cannot be a part of their internal control. How an auditor responds to a client’s internal control weakness, in terms of designing and carrying out further auditing procedures, does not affect or mitigate a client’s internal control weakness. Just as an auditor’s response to detection risk is independent of the client’s control risk, so too the auditor’s response to a control weakness does not change the control weakness. Only the client—not the auditor—can correct deficiencies in internal control. However, a CPA firm other than the auditor can be part of a client’s internal control. This may raise new questions regarding the role of outsourcing in achieving management’s internal control objectives.

.35 The auditor may need to hold discussions with management and other users who ask how it is possible to express an unqualified opinion on the financial statements when material weaknesses in internal control were present. The auditor may wish to explain that the audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client’s internal control. The auditor can express an unqualified opinion on the financial statements even though material weaknesses in internal control are present, by performing sufficient procedures and obtaining appropriate audit evidence to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not correct deficiencies in internal control; the deficiencies in internal control could still result in a material misstatement not being prevented or detected by the client.

**Issues for Audits of Smaller Entities**

.36 One issue that may arise in audits of smaller entities is the possibility of increased costs as a result of the auditor’s time spent documenting his or her evaluation of internal control and evaluating identified deficiencies in internal control.
Another issue that may cause concern is the extent to which the auditor may be involved in the drafting of an entity’s financial statements. It is a strong indication of material weakness in internal control if the audit client has ineffective controls over the preparation of their financial statements such that client controls are absent or controls are not effective in preventing or detecting material misstatements in the preparation of financial statements, including the related footnotes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client’s controls, including monitoring ongoing activities, because doing so would impair independence.3

Opportunities to Expand Client Services

The requirements of SAS No. 112 and now SAS No. 115 introduce possible opportunities to educate the client in ways that will improve their internal control. Auditors can help clients evaluate the cost/benefit implications of improving their internal control; including training their personnel to be more knowledgeable about accounting, financial statement presentation, and internal control design. Additionally, auditors can teach clients how to develop a risk assessment approach to designing internal control.

Examples

Deficiencies in Internal Control, Significant Deficiencies, or Material Weaknesses

Exhibit B in SAS No. 115 provides examples of circumstances that may be deficiencies in internal control, significant deficiencies, or material weaknesses. This appendix includes one example in addition to those contained in the appendix to SAS No. 112. The following are the items included in the appendix within AU section 325 paragraph .29.

- Deficiencies in the design of controls
  - Inadequate design of controls over the preparation of the financial statements being audited.
  - Inadequate design of controls over a significant account or process.
  - Inadequate documentation of the components of internal control.
  - Insufficient control consciousness within the organization; for example, the tone at the top and the control environment.
  - Absent or inadequate segregation of duties within a significant account or process.
  - Absent or inadequate controls over the safeguarding of assets (this applies to controls that the auditor determines would be necessary for effective internal control over financial reporting).
  - Inadequate design of IT general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.
  - Employees or management who lack the qualifications and training to fulfill their assigned functions. For example, in an entity that prepares financial statements in accordance with generally accepted accounting principles (GAAP), the person responsible for the accounting and reporting function lacks the skills and knowledge to apply GAAP in recording the entity’s financial transactions or preparing its financial statements.
  - Inadequate design of monitoring controls used to assess the design and operating effectiveness of the entity’s internal control over time.

The absence of an internal process to report deficiencies in internal control to management on a timely basis.

- Failures in the operation of internal control
  - Failure in the operation of effectively designed controls over a significant account or process; for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process.
  - Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy; for example, the failure to obtain timely and accurate consolidating information from remote locations that is needed to prepare the financial statements.
  - Failure of controls designed to safeguard assets from loss, damage, or misappropriation.
  - Failure to perform reconciliations of significant accounts. For example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner.
  - Undue bias or lack of objectivity by those responsible for accounting decisions; for example, consistent understatement of expenses or overstatement of allowances at the direction of management.
  - Misrepresentation by entity personnel to the auditor (an indicator of fraud).
  - Management override of controls.
  - Failure of an application control caused by a deficiency in the design or operation of an IT general control.
  - An observed deviation rate that exceeds the number of deviations expected by the auditor in a test of the operating effectiveness of a control. For example, if the auditor designs a test in which he or she selects a sample and expects no deviations, the finding of one deviation is a nonnegligible deviation rate because, based on the results of the auditor’s test of the sample, the desired level of confidence was not obtained.

.40 Note that the third circumstance in the preceding list, failure of controls designed to safeguard assets from loss, damage, or misappropriation, may need careful consideration before it is evaluated as a significant deficiency or material weakness. For example, assume that a company uses security devices to safeguard its inventory (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its financial reporting. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement of the financial statements if performed effectively and timely.

.41 Therefore, given that the definitions of material weakness and significant deficiency relate to the likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness if the detective control (physical inventory) prevents a misstatement of the financial statements. Material weaknesses relating to controls over the safeguarding of assets would only exist if the company does not have effective controls (considering both safeguarding and other controls) to prevent or detect a material misstatement of the financial statements.

**Significant Deficiencies**

.42 Some examples of deficiencies that might indicate the existence of significant deficiencies in internal control:

- Controls over the selection and application of accounting principles that are in conformity with GAAP; having sufficient expertise in selecting and applying accounting principles is an aspect of such controls
- Antifraud programs and controls
• Controls over nonroutine and nonsystematic transactions

• Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements

Material Weaknesses

.43 Some examples of circumstances that indicate a deficiency in internal control that could be regarded as material weaknesses in internal control are

• identification of fraud, whether or not material, on the part of senior management;
• restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud;
• identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected by the entity’s internal control; and
• ineffective oversight of the entity’s financial reporting and internal control by those charged with governance.

Evaluation Questions

.44 When evaluating the severity of a deficiency in internal control, the first step is to determine whether the deficiency is a material weakness. Some questions to consider when making this determination include the following:

• Is the probability that a misstatement of any magnitude could occur and not be detected and corrected on a timely basis by the client’s controls reasonably possible?
• Is the magnitude of a potential misstatement material to the financial statements? A misstatement is material, either individually or when aggregated with other misstatements, would cause the entity’s financial statements to be materially misstated.

.45 If the answer to both questions is yes, then the deficiency is a material weakness. After that determination is made, the auditor may consider additional factors that could mitigate the affect of deficiency in internal control to the point where it can be classified as a deficiency in internal control or significant deficiency in internal control. Consider the answers to the following questions:

• Are there complementary or redundant controls that were tested and evaluated that achieve the same control objective?
• Are there compensating controls that were tested and evaluated that limit the magnitude of a misstatement of the financial statements to less than material?

.46 If the answer to either question is yes, the auditor may evaluate whether the deficiency in internal control is sufficiently mitigated to classify it as less severe than a material weakness in internal control. Before concluding that the control deficiency is not a material weakness, the auditor should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion. Deficiencies considered less severe than material weaknesses but important enough to merit the attention of those charged with governance would be classified as significant deficiencies.
Case Studies

This section contains case studies that highlight a particular deficiency in internal control. Each case study contains a description of the deficiencies in internal control, and an analysis of the assessment of the severity of the deficiency. The deficiencies in internal control discussed are as follows:

- Lack of segregation of duties
- Lack of client expertise in financial accounting and reporting
- Inventory-related deficiencies in internal control
- Failure to review modifications of standard sales contracts to evaluate their effect on the timing and amount of revenue recognition
- Fraud involving cash
- Control testing exceptions

Deficiency in Internal Control 1: Lack of Segregation of Duties

Situation 1

Your client is a small nonprofit organization that has only one person in charge of the accounting and reporting functions. Through your understanding of controls over cash disbursements, you observe a lack of segregation of duties, which is a deficiency in internal control. In assessing the severity of the deficiency in internal control, you consider whether complementary, redundant, or compensating controls exist.

Additional Facts. Through obtaining your understanding of internal control, you’ve learned that a board member signs all checks, reviewing invoices that support the disbursement before signing. The signed checks are returned to the client to be mailed. The bank sends the bank statement directly to the board member, who reviews the bank statement and returned checks. The bank statement is then given to the client for reconciliation.

Discussion. Your assessment of the severity of this deficiency in internal control would be based on the effectiveness of the compensating controls performed by the board members. The compensating controls do not eliminate the deficiency but may mitigate the effects of the deficiency in internal control.

If the board member does not perform a review of the bank statement and the returned checks, verifying that all the checks have the appropriate signature and that the check payee and amount have not been altered, you might determine that the compensating control over disbursements is not effective in achieving the control objective and, therefore, a material weakness exists.

If the board member reviews only returned checks over a certain dollar amount, you might conclude that the compensating control is effective in preventing or detecting a material misstatement of cash and, therefore, this may be considered a significant deficiency because the magnitude of the reasonably possible misstatement is less than material.

However, if the board member examines the returned checks for the appropriate signature and alterations, you might conclude that the compensating control is effective in preventing or detecting an unauthorized disbursement, making the likelihood of a misstatement remote; therefore, this is only a deficiency in internal control and not a significant deficiency or material weakness.

Situation 2

Your client is a small business that has only one person in charge of the accounting and reporting functions. The bookkeeper has been with the company for many years. It is common for the owner to leave
signed, blank checks with the bookkeeper, “in case of emergencies” when the owner is gone. The owner does not perform any oversight procedures. The owner has you, the auditor, perform quarterly interim procedures. The owner believes the auditors are a substitute for his lack of oversight. One of the auditor’s quarterly procedures is to review the bank reconciliation, which is prepared by the bookkeeper.

.55 Discussion. Because the auditor cannot be part of the client’s internal control, your interim procedures, including your review of the bank reconciliations, are not compensating controls. Should the bookkeeper betray the owner’s trust, the magnitude of a potential misstatement could reasonably be expected to be material. In your professional judgment, you believe that a reasonable person would conclude that there is a reasonable possibility that a misstatement could occur and not be caught by the owner. Thus, the lack of segregation of duties and the lack of oversight would be considered material weaknesses.

Deficiency in Internal Control 2: Lack of Client Expertise in Financial Accounting and Reporting

.56 In situations 3, 4, and 5, you provide assistance to your client in the drafting of the financial statements but, as the auditor, remain independent under Ethics Interpretation 101-3, Performance of Nonattest Services, under Rule 101, Independence (AICPA, Professional Standards, vol. 2, ET sec. 101par. .05). That is, you post client-approved adjusting entries to the trial balance and assist in the drafting of the financial statements from the trial balance. You are not responsible for approving adjusting entries.

Situation 3

.57 Your client’s controller is fairly skilled and is able to perform most of the functions necessary to prepare the financial statements. However, the company does not maintain a fixed asset ledger. Rather, you maintain a fixed asset ledger for them on your computer using “off-the-shelf” fixed asset software. From this software package, you are able to print for the controller a projected depreciation schedule, a gain and loss calculation report based on cost, and sales information provided to you by the controller and a final depreciation and fixed asset listing at year-end. The controller provides adequate supervision of the depreciation calculation to ensure that no conflict with Interpretation 101-3 exists. The book and tax depreciation calculation affects depreciation expense for book purposes and also the calculation of deferred taxes. The client could purchase a depreciation program but has concluded it is more cost effective to rely on you for these records.

.58 In most years, the controller provides you with a year-end adjustment if adjustments hadn’t already been made to the general ledger. However, in this particular year, the controller has been preoccupied with other tasks and asks you to calculate the year-end depreciation adjustment and gain or loss on sale adjustment. The adjustment is a material adjustment. Because you propose the adjustment, you need to consider whether a deficiency in internal control exists.

.59 Discussion. In this situation, you would begin by considering whether there is a reasonable possibility that a misstatement would not be detected. Because the auditor cannot be part of a client’s internal controls, the controls that exist in your CPA firm to perform the calculations cannot be taken into account in considering whether the client has a deficiency in internal control. Instead, you should consider what controls the client has to detect a misstatement. Based on only these facts, your judgment is that the client has the competency to perform the accounting function but has chosen not to perform these depreciation closing procedures this year.

.60 However, as long as the client reviews the depreciation and related calculations, and you believe such review procedures would prevent, detect, and correct potential misstatements, you may determine that there is not a deficiency in internal control. If the client’ procedures or controls are not able to prevent, detect, and correct a misstatement, then you would determine that there is a deficiency in internal control.
Situation 4

.61 This client has an accounting manager who requests that you assist in drafting the financial statements and notes to the financial statements. However, prior to signing the representation letter, the accounting manager obtains the financial statement grouping schedules and the schedules documenting the calculation of amounts included in the notes to the financial statements, and reviews and approves these schedules. In addition, the accounting manager obtains a current disclosure checklist from the AICPA and reviews and answers the checklist to ensure propriety and completeness of the footnotes. The financial statements are also read, revised, and approved by both the accounting manager and the owner.

.62 Discussion. Based only on the facts presented, no deficiencies in internal control were observed. You would need to further understand whether the client’s controls are designed appropriately and operating effectively, and that would be dependent on the competence and expertise of the client’s accounting manager.

.63 In assessing this situation, you would first consider whether a reasonable possibility exists that a material misstatement in the presentation and disclosure of the financial statements, including the related footnotes, could occur without being detected by the accounting manager. If you determine that the accounting manager and owner lack the necessary accounting expertise to detect a misstatement, then that would represent a deficiency in internal control that would need to be evaluated.

.64 However, you might conclude that, despite the accounting manager asking you to assist in drafting the financial statements and footnotes, they (the accounting manager and owner) do possess the necessary accounting expertise to perform effective controls to prevent, detect, and correct a potential misstatement in the financial statements or notes; therefore, you would not have a deficiency in internal control.

Situation 5

.65 At this client, you taught the bookkeeper to record cash receipts and disbursements as well as the adjusting journal entries needed to record accounts receivable and payable at year-end. The bookkeeper follows your directions and prepares a draft of the year-end financial statements from a format you provided, including relevant recurring disclosures.

.66 During your audit, you notice that the owner acquired a new delivery truck that cost $50,000—an amount that is material to the company’s financial statements—and financed the acquisition through the dealer’s finance company. You determine that the financing lease should be capitalized. The bookkeeper has recorded the monthly cash payments for the truck to the dealership but has not recorded the initial fixed asset and related liability (the owner had told her that he was leasing the truck). In discussing the new truck with the bookkeeper, you further discover that the owner was involved in a collision on the last day of the year while driving the truck, and the company’s insurance covered only a small portion of the damages. The financial statements do not reflect the capital lease and the related liability, nor does it reflect the expense and liability for the damages in excess of the company’s insurance.

.67 Discussion. Based only on these facts, you determine that a deficiency in internal control exists because the internal control system did not detect, prevent, or correct the misstatements in the client’s drafted financial statements. Because you caught this error, your judgment is that it is reasonably possible that the financial statements would be misstated, and the magnitude of the misstatement is material. Because you are the auditor, you cannot be part of the company’s internal control. The company did not have anyone on staff with sufficient expertise to properly analyze the lease and record the fixed asset acquisition, and the bookkeeper was not sufficiently knowledgeable to know that she needed help in recording these events. In this case, the quality of the financial statements was not a result of the company’s internal control. As such, you determine that the entity has a material weakness.
.68 If the bookkeeper had called you for guidance about how to account for these events, before recording them, your conclusion may have been different. A discussion with the client about a technical issue is not, in and of itself, an indication of a weakness in the company’s internal control. The client’s ability to exercise controls to detect a potential misstatement and to gain the necessary competence is a factor you would consider in your understanding of the entity’s internal control.

**Deficiency in Internal Control 3: Inventory-Related Deficiencies in Internal Control**

**Situation 6**

.69 Your client is a large car dealership. There is a lack of good controls over tracking inventory quantities of dealership parts, but a physical inventory is taken at the end of every quarter. A parts manager was selling dealership parts, not recording the sales, and keeping the receipts. Although the amount of the writedown needed to reflect actual inventory was not material to the financial statements, management became aware of the fraud when the parts manager confessed under questioning.

.70 **Discussion.** The purpose of your evaluation is to assess the probability and potential magnitude of a financial statement misstatement, not the likelihood and potential magnitude of a loss due to fraud. Because the preventive controls tracking inventory quantities are weak, the client is relying on detective controls—physical inventory—to catch any potential misstatement. From a design perspective, detective controls are seldom as effective as preventive controls, as evidenced by the fact that the client suffered a loss as a result of the weak preventive controls. However, the physical inventory was effective at detecting the loss, so that the financial statements were not materially misstated. Because you would consider the effect of compensating controls in your assessment of the severity of the deficiency in internal control, you would conclude that the preventive control weakness is mitigated by the detection control to the extent that neither a significant deficiency nor a material weakness in internal control over financial reporting exists.

.71 Although the fraud did not result in a material misstatement of the financial statements, the fraud is evidence of a deficiency in internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition. AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), requires that whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. Therefore, you may wish to include this misappropriation (and other risks of fraud that you have identified) in your written communication of significant deficiencies and material weaknesses.

**Deficiency in Internal Control 4: Failure to Review Modifications of Standard Sales Contracts to Evaluate Their Effect on the Timing and Amount of Revenue Recognition**

**Situation 7**

.72 Your client uses a standard sales contract for most transactions. Individual sales transactions are not material. Sales personnel are permitted to modify the terms of the sales contract, including shipping terms. Accounting personnel review the terms of the sales contracts for significant or unusual modifications but do not review changes in the standard shipping terms. The changes in the standard shipping terms could cause a delay in the timing of revenue recognition. Management reviews gross margins on a monthly basis and investigates any significant or unusual relationships. In addition, management reviews the reasonableness of inventory levels at the end of each accounting period. There have been a limited number of instances in which revenue was inappropriately recorded, but the related amounts have not been material.

.73 **Discussion.** Based on only these facts, you determine that a deficiency in internal control exists in the design of the entity’s controls because no controls are in place to monitor a sales person’s ability to modify the standard sales contract. In evaluating the severity of this deficiency in internal control, you consider the
probability and potential magnitude of a financial statement misstatement resulting from this deficiency. The magnitude could reasonably be expected to be less than material, because individual sales transactions are not material and the compensating controls that mitigate the deficiency, which operate monthly and at the end of each financial reporting period, increase the probability that a material misstatement will be detected. Furthermore, the risk of material misstatement is limited to revenue recognition errors related to shipping terms, as opposed to broader sources of error in revenue recognition.

.74 However, the compensating controls are designed to detect only material misstatements. The controls do not effectively address the detection of misstatements that are less than material, as evidenced by situations in which transactions that were not material were improperly recorded. Therefore, there it is reasonably possible a misstatement that is less than material could occur. If you determined that this deficiency was important enough to merit the attention of management or those charged with governance, you would conclude that this deficiency is a significant deficiency.

Situation 8

.75 Your client has a standard sales contract, but sales personnel frequently modify the terms of the contract. Certain modifications can affect the timing and amount of revenue recognized. Individual sales transactions frequently are material to the entity, and the gross margin can vary significantly for each transaction.

.76 Through your understanding of internal control necessary to plan the audit, you determine that the entity has a design deficiency in that the entity does not have procedures in place for accounting personnel to regularly review modifications to the terms of sales contracts. Although management reviews gross margins on a monthly basis, the significant differences in gross margins for individual transactions make it difficult for management to identify potential misstatements. Improper revenue recognition has occurred in the past, and the amounts have been material.

.77 Discussion. The magnitude of a financial statement misstatement resulting from this deficiency in internal control would reasonably be expected to be material because individual sales transactions are frequently material, and gross margin can vary significantly with each transaction (which would make compensating controls based on a reasonableness review ineffective). Additionally, improper revenue recognition has occurred, and the amounts have been material. Therefore, the likelihood of material misstatements occurring is reasonably possible. Because, taken together, the magnitude and probability of misstatement of the financial statements resulting from this internal deficiency in internal control is material, you determine that this deficiency is a material weakness.

Situation 9

.78 The entity has a standard sales contract; however, sales personnel frequently modify the terms of the contract. Sales personnel frequently grant unauthorized and unrecorded sales discounts to customers without the knowledge of the accounting department. These discounts are taken by customers, deducted from the amount paid, and recorded as outstanding balances in the accounts receivable aging. Although the amounts of these discounts are individually insignificant, they are material in the aggregate and have occurred consistently during the past few years.

.79 Discussion. The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because the frequency of occurrence allows insignificant amounts to become material in the aggregate. It is reasonably possible that a material misstatement of the financial statements would result from this deficiency in internal control (even if the client fully reserved for the uncollectible accounts) due to the probability of material misstatement of the gross accounts receivable balance. Therefore, your judgment is that this deficiency represents a material weakness.
Deficiency in Internal Control 5: Fraud Involving Cash

Situation 10

.80 Your client is a small not-for-profit organization that receives most donations by check from corporate donors. Some donations are made in cash. Cash donations are not material to the financial statements. As a result of your understanding of internal control, you notice that internal control over cash receipts is inadequate. In planning your audit, you identify this as a fraud risk and you perform additional auditing procedures relative to cash receipts. Through inquiry, you learn that someone may be stealing cash. You notify management and as a result of performing certain audit tests you discover evidence that indicates that an employee was pocketing the cash and that cash donations were not being recorded.

.81 Discussion. Your judgment is that it is reasonably possible that a misstatement exists because the fraud has already occurred. The magnitude of the potential financial statement misstatement resulting from this deficiency would reasonably be expected to be less than material, as total cash sales are less than material. At a minimum, you determine that the matter is important enough that it merits the attention of those charged with governance. Thus, this deficiency is at least a significant deficiency. However, because your client is a not-for-profit organization and cash is a sensitive area, and because fraud is involved, you step back and try to look at this situation from a prudent official’s perspective. You consider how a regulator may view this, how a donor may view this, and how others in the nonprofit community may view this. In doing that, your judgment is that a prudent official would probably view an absence of controls over cash receipts as a material weakness. Therefore, you conclude that this is a material weakness.

Deficiency in Internal Control 6: Control Testing Exceptions

Situation 11

.82 In performing tests of controls during the audit, you identify an exception. You determined that the exception was one of numerous internal control exceptions that occurred during the two weeks that the controller was on vacation. Controls operated effectively before he left and after he returned to work. No misstatements in the financial statements were identified relating to that period of time.

.83 Discussion. You first need to determine whether the control testing exception is a deficiency in internal control before considering the severity of that deficiency in internal control. Effective internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting. Because effective internal control over financial reporting cannot and does not provide absolute assurance of achieving financial reporting objectives, any individual control does not necessarily have to operate perfectly, all the time, to be considered effective. You may want to gather additional evidence, beyond what you had initially planned and beyond inquiry, to support your conclusion that the exception does not represent a deficiency in internal control.

.84 You cannot use the lack of actual misstatements to lessen the severity of the deficiency in internal control in your determination, because you have to consider potential misstatements of any magnitude. Factors to consider in making your determination would include complementary, redundant, or compensating controls, which could include the monitoring activities undertaken by the controller upon returning from vacation.

Resource Central

.85 The following resources may be beneficial to practitioners and their clients.

Publications

.86 Practitioners may find the following publications useful. Choose the format best for you—online, print, or CD-ROM.
AICPA reSOURCE: Accounting and Auditing Literature

The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm’s needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to the AICPA’s latest Professional Standards, Technical Practice Aids, Audit and Accounting Guides (more than 20), Audit Risk Alerts (more than 15), and Accounting Trends & Techniques. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Continuing Professional Education

The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- **Internal Control and IT: Reliable Reporting and Fraud Prevention**, a CPE course that provides an overview of the key auditing standards, conceptual frameworks, IT infrastructures, and auditing issues you are likely to face on medium to small company engagements. (Product no. 732553)

- **Internal Control Essentials for Financial Managers, Accountants and Auditors**, a basic course designed to give participants a solid understanding of systems and control documentation at the significant process level. This course will benefit controllers, managers, and internal auditors in businesses as well as auditors and consultants to public and private companies who need a review. (Product no. 731853kk)

Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz, is AICPA’s flagship online learning product. AICPA members pay $180 for a new subscription and $149 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics including

- **Internal Controls: Risk Assessment and Fraud - An In-Depth Review**
- **Internal Controls: Controls for Smaller Entities**
- **Internal Controls: The Control Environment - An In-Depth Review**

Webcasts

Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession’s leading
experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.

**CFO Quarterly Roundtable Series**

.91 The CFO Quarterly Roundtable Series, brought to you each calendar quarter via webcast, covers a broad array of “hot topics” that successful organizations employ and subjects that are important to the CFO’s personal success. From financial reporting, budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

**SEC Quarterly Update Series**

.92 The Securities and Exchange Commission (SEC) Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession’s leading experts on what is “hot” at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you “plugged in” to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

**Member Service Center**

.93 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

**Hotlines**

**Accounting and Auditing Technical Hotline**

.94 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA’s Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. Beginning January 14, 2008, hotline hours were extended so that the hotline is now available from 9 a.m. to 8 p.m. on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help.

**Ethics Hotline**

.95 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA’s Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

**AICPA Governmental Audit Quality Center**

.96 The Governmental Audit Quality Center (GAQC) is a firm-based, voluntary membership center designed to help CPAs meet the challenges of performing quality audits in this unique and complex area. The GAQC’s primary purpose is to promote the importance of quality governmental audits and the value of such audits to purchasers of governmental audit services. The GAQC also offers resources to enhance the quality of a firm’s governmental audits.

.97 The mission of the GAQC is to do the following:

- Raise awareness about the importance of governmental audits
- Serve as a comprehensive resource provider on governmental audits for member firms
• Create a community of firms that demonstrates a commitment to governmental audit quality
• Provide center members with an online forum tool for sharing best practices and discussing audit, accounting, and regulatory issues
• List member firms to enable purchasers of governmental audit services to identify firms that are members
• Provide information about the center’s activities to other governmental audit stakeholders

For more information about the GAQC, visit http://gaqc.aicpa.org.

The Center for Audit Quality

.98 The Center for Audit Quality (CAQ), which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ’s mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession’s core values of integrity, objectivity, honesty, and trust.

.99 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit http://thecaq.aicpa.org.

Employee Benefit Plan Audit Quality Center

.100 The AICPA Employee Benefit Plan Audit Quality Center is a firm-based, voluntary membership center created in March 2003 with the goal of promoting quality employee benefit plan audits. The center now has more than 1,500 members in all 50 states, the District of Columbia, the U.S. Virgin Islands, and Puerto Rico.

.101 Reviews performed by the U.S. Department of Labor’s Employee Benefits Security Administration continue to show a difference in the quality of Employee Retirement Income Security Act audits performed by center member firms compared with those performed by nonmember firms. As members of the center, firms have tools and resources that are not available from any other source. In addition to providing periodic e-alerts with information about recent developments affecting employee benefit plan audits, the center has recently made available to its members

• “Live Forum” and “Roundtable Discussion” conference calls to share important information and answer participant questions on a wide range of technical and practice topics. As an added benefit, the center now offers a CPE option for most calls.
• two new “Topix” primers on cash balance plans and Section 403(b) plans to help members gain a general understanding of these types of plans.
• three new “Plan Advisories” for members to share with plan stakeholders about issues of importance for plan auditors, including the plan sponsor and trustees’ responsibility for monitoring their TPAs, the importance of internal controls, and the plan sponsor’s responsibility for valuing plan investments.

.102 Visit the center Web site at www.aicpa.org/ebpaqc to see a complete list of center members and to preview center benefits. For more information, contact the center at ebpaqc@aicpa.org.
Antifraud/Forensic Accounting Resource Center

.103 The AICPA’s Antifraud/Forensic Accounting Resource Center may be found at www.aicpa.org/antifraud/. The center contains a variety of tools for auditors, financial managers and those charged with governance. Topics covered in the resource center include identifying internal control risk factors and fraud prevention, detection and investigation in a variety of practical formats including checklists, guides, and case studies.

Audit Committee Effectiveness Center

.104 Realizing that financial statement integrity and reliability depends upon balancing the pressures of multiple stakeholders, including management, regulators, investors, and the public interest, this center provides guidance and tools to make audit committee best practices actionable. Several audit committee toolkits are offered through this center, including those for public companies, not-for-profits, and governments.

Audit Committee Matching System

.105 The Audit Committee Matching System was designed to provide members with opportunities to serve on boards of directors and as a public service to provide a list of qualified, credentialed candidates to serve on boards of directors and presumably the audit committees of those boards. The AICPA’s Audit Committee Effectiveness Center Web page at www.aicpa.org/audcommctr/homepage.htm also contains a link to the Audit Committee Matching System.

* * * *

This Audit Risk Alert replaces Understanding SAS No. 112 and Evaluating Control Deficiencies.

As you encounter audit or industry issues that you believe warrant discussion in an AICPA Audit Risk Alert, please feel free to share them with us. Any other comments that you have about this Audit Risk Alert would also be appreciated. You may e-mail these comments to ccole@aicpa.org or write to

Christopher Cole, CPA, CFE, CFF
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

[The next page is 901.]
These examples are for illustrative purposes only. They are included as conveniences for users of this manual who may want points of departure when drafting reports to meet their individual needs. This manual is a nonauthoritative kit of practice aids and, accordingly, does not include extensive explanation or discussion of authoritative pronouncements. Please refer directly to applicable authoritative pronouncements when appropriate.

These examples illustrate the body of various reports. For comment on addressing and dating of the report, see AAM section 9100.

Examples that are assembled from illustrative reporting language set forth in Statements on Auditing Standards (SASs) and Statements on Standards for Accounting and Review Services include citation of the particular source and its location in AICPA Professional Standards.

References to Professional Standards. When referring to the professional standards, this manual cites the applicable sections as codified in the AICPA Professional Standards and not the numbered statements, as appropriate. For example, SAS No. 54, Illegal Acts by Clients, is referred to as AU section 317 of the AICPA Professional Standards. All references to AU sections may be found in AICPA Professional Standards, volume 1.

**TABLE OF CONTENTS**

<table>
<thead>
<tr>
<th>Section</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>9100</td>
<td>Format of Accountants’ Reports ................................................. 01-39</td>
</tr>
<tr>
<td></td>
<td>Report Preparation ................................................................. 01</td>
</tr>
<tr>
<td></td>
<td>Reports on Audited Financial Statements ...................................... 02</td>
</tr>
<tr>
<td></td>
<td>Standard Report ................................................................. 03</td>
</tr>
<tr>
<td></td>
<td>Modifications of the Standard Auditor’s Report .............................. 04</td>
</tr>
<tr>
<td></td>
<td>Scope Limitations ............................................................... 05</td>
</tr>
<tr>
<td></td>
<td>Departures From GAAP ............................................................. 06-09</td>
</tr>
<tr>
<td></td>
<td>Errors, Fraud, and Illegal Acts .................................................. 10-11</td>
</tr>
<tr>
<td></td>
<td>Consistency Exceptions ............................................................ 12-14</td>
</tr>
<tr>
<td></td>
<td>Uncertainties ................................................................. 15-22</td>
</tr>
<tr>
<td></td>
<td>Reporting on Supplementary Information ........................................... 23-24</td>
</tr>
<tr>
<td></td>
<td>Reporting on a Single Statement .................................................. 25</td>
</tr>
<tr>
<td></td>
<td>Relying on the Work of a Specialist .................................................. 26-27</td>
</tr>
<tr>
<td></td>
<td>Lack of Independence ............................................................. 28-30</td>
</tr>
<tr>
<td></td>
<td>Reissuance of Audit Reports as Predecessors .................................... 31-33</td>
</tr>
<tr>
<td></td>
<td>Reissuance of the Audit Report Subsequent to the Date of Original Issue .... 34-35</td>
</tr>
<tr>
<td></td>
<td>Subsequent Discovery of Facts Existing at Report Date ........................ 36-39</td>
</tr>
<tr>
<td>Section</td>
<td>Description</td>
</tr>
<tr>
<td>---------</td>
<td>------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>9210</td>
<td>Unqualified Opinions</td>
</tr>
<tr>
<td>9220</td>
<td>Adverse Opinions</td>
</tr>
<tr>
<td>9230</td>
<td>Disclaimers of Opinion</td>
</tr>
<tr>
<td>9240</td>
<td>Qualified Opinions</td>
</tr>
<tr>
<td>9245</td>
<td>Information Accompanying Audited Financial Statements</td>
</tr>
<tr>
<td>9250</td>
<td>Engagements to Report on Internal Control</td>
</tr>
<tr>
<td>9260</td>
<td>Special Reports</td>
</tr>
<tr>
<td>9270</td>
<td>Unaudited Financial Statements of a Public Entity</td>
</tr>
<tr>
<td>9280</td>
<td>Lack of Independence</td>
</tr>
<tr>
<td>9300</td>
<td>Review of Interim Financial Information</td>
</tr>
<tr>
<td>9400</td>
<td>Accountants’ Reports on Condensed Financial Statements and Selected Financial Data</td>
</tr>
<tr>
<td>9500</td>
<td>Reports on Personal Financial Statements</td>
</tr>
<tr>
<td>9600</td>
<td>Reports on Employee Benefit Plans</td>
</tr>
<tr>
<td>9650</td>
<td>Reports on Financial Statements of Brokers and Dealers in Securities</td>
</tr>
<tr>
<td>9700</td>
<td>Reports for Investment Companies</td>
</tr>
</tbody>
</table>
AAM Section 9100

Format of Accountants’ Reports

Report Preparation

.01 Firms usually develop standard policies and procedures for preparing and issuing reports. The following are some suggested report preparation policies that the auditor may consider:

- **Letterhead.** The report is typically presented on firm letterhead.

- **Addressee.** The report may be addressed to the board of directors, stockholders, partners, general partners, proprietors, or to the company whose financial statements are being audited. If the firm was engaged by others, the report may be addressed thereto.

  The Board of Directors  
  XYZ Credit Union  
  City, State Zip Code

- **Salutation.** A salutation is not typically included on the report.

- **Report signing.** The firm name is usually manually signed by the engagement partner. The words “Certified Public Accountants” may be excluded from the signature if they are a normal part of the firm’s letterhead.

- **Report dating.** Audit reports should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion.
  
  — The date is typically presented at the bottom of the page along with the city and state, if it is not included in firm letterhead, as follows:

    City, State  
    April 5, 20XX

  — When a subsequent event disclosed in the financial statements occurs after the original date of the auditor’s report but before the issuance of the related financial statements, the auditor may use dual dating or date the report as of the later date. The following illustrates dual dating:

    City, State  
    February 26, 20XX, except for Note X as to which the date is April 5, 20XX

- **Level of service.** The level of service performed and the nature of the report are typically outlined in the engagement letter. The letter should be revised for any significant changes from the original understanding with the client, such as in the event of a step-up or step-down in the level of service.
  
  — The partner typically approves any step-up or step-down in level of service. A step-up in level of service may occur after obtaining a revised understanding with the client. The auditor may consider a step-down in level of service only after carefully evaluating the reasons for the change because the reasons for the change may also affect the report on lower levels of service. Limitations on the scope of an audit, for example, may also preclude issuing a review or compilation report.

  — If more than one level of service is performed for financial statements of the same period (for example, compilation and audit), the financial statements need only be accompanied by the report on the highest level of service performed.
Reports on Audited Financial Statements

.02 Generally accepted auditing standards (GAAS) establish reporting responsibilities. Following are the four standards of reporting\(^1\) stated in paragraph .02 of AU section 150, Generally Accepted Auditing Standards (AICPA, Professional Standards, vol. 1):

a. The auditor must state in the auditor’s report whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).\(^2\)

b. The auditor must identify in the auditor’s report those circumstances in which GAAP has not been consistently applied in the current period in relation to the preceding period.

c. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor’s report.

d. The auditor must either express an opinion regarding the financial statements taken as a whole or state that an opinion cannot be expressed in the auditor’s report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefor in the auditor’s report. In all cases where an auditor’s name is associated with financial statements, the auditor should clearly indicate the character of the auditor’s work, if any, and the degree of responsibility the auditor is taking in the auditor’s report.

Standard Report

.03 The standard auditor’s report prescribed by AU section 508, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1), may be used when the auditor has formed an opinion, based on the application of GAAS,\(^3\) that the financial statements present fairly, in all material respects, an entity’s financial position, results of operations, and cash flows in accordance with GAAP. The opinion should include an identification of the United States of America as the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. GAAP). It should state that the financial statements identified in the report were audited. A standard auditor’s report for the presentation of comparative financial statements is illustrated in paragraph .01 of AAM section 9210.

Modifications of the Standard Auditor’s Report

.04 AU section 508 describes situations that may require auditors to modify the standard report and also provides illustrations of the appropriate modifying language. These modifications, which are discussed in greater depth subsequently, are as follows:

- **Explanatory language.** A wide variety of situations may arise that require a modification of the standard auditor’s report, without affecting the expression of an unqualified opinion. Some of the more common of such situations are going-concern problems, part of the financial statements have been audited by another auditor, or a significant change in accounting principles. The explanatory paragraph for situations that do not affect the auditor’s opinion may precede or follow the opinion paragraph, unless otherwise required by AU section 508.

- **Qualified opinion.** Qualified opinions result from two general categories of situations: scope limitations and departures from GAAP. A scope limitation arises when the auditor has been unable to perform all of the auditing procedures he or she believes are necessary to express an unqualified opinion on

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\(^1\) The reporting standards apply only when the auditor issues a report.

\(^2\) When an auditor reports on financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles (GAAP), the first standard of reporting is satisfied by stating in the auditor’s report that the basis of presentation is a comprehensive basis of accounting other than GAAP and by expressing an opinion (or disclaiming an opinion) on whether the financial statements are presented in conformity with the comprehensive basis of accounting used.

\(^3\) Paragraph .08 of AU section 508, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1), indicates that one of the basic elements of the standard report is an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards [GAAS]).
the financial statements. Financial statements containing a material departure from GAAP, including inadequate disclosures in the financial statements, may lead the auditor to qualify his or her opinion. Both situations require an explanatory paragraph to be included, preceding the opinion paragraph, describing the nature of the scope limitation or the departure from GAAP.

- **Disclaimer of opinion.** A disclaimer of opinion is appropriate when
  
  - the scope of the audit has been restricted so significantly that the auditor does not have a basis for forming an opinion on the financial statements. In this case, an explanatory paragraph, preceding the disclaimer paragraph, should be included in the auditor’s report to explain all significant reasons for the disclaimer.
  
  - the auditor is not independent, in which case a one paragraph disclaimer is issued (applies for issuers only). A compilation report with a lack of independence noted should be issued for nonissuers entities.

- **Adverse opinion.** An adverse opinion is expressed on financial statements that do not present fairly the entity’s financial position, results of operations, or cash flows in conformity with GAAP. In other words, the auditor concludes that the financial statements are not fairly presented in accordance with GAAP. When the auditor expresses an adverse opinion, he or she should disclose in a separate explanatory paragraph, preceding the opinion paragraph, all of the substantive reasons for the adverse opinion and, if practical, the effects of the subject matter of the adverse opinion on the financial statements.

### Scope Limitations

.05 Restrictions on the scope of an audit, whether imposed by the client or by circumstances such as the timing of the auditor’s work, the inability to obtain sufficient competent audit evidence, or an inadequacy in the client's accounting records, may require a qualified opinion or a disclaimer of opinion. Deciding whether to qualify or disclaim is a matter of judgment, and generally the primary factor in this decision is the materiality of the financial statement items affected. However, other factors may be considered, such as the pervasiveness of the effects of the omitted auditing procedures and the nature of the financial statement items affected.

### Departures From GAAP

.06 **Unacceptable Principles.** When financial statements are materially affected by a departure from GAAP, the auditor should express either a qualified or adverse opinion. Choosing between a qualified or adverse opinion depends on the magnitude of the departure. While the materiality of the effects of the departure is a primary consideration, the auditor may also consider the pervasiveness of the departure (such as the number of financial statement items affected), the importance of the departure to the organization’s activities and its ability to obtain funding, and the dollar effect of the departure on individual financial statement items as well as the statements as a whole.

.07 For both qualified and adverse opinions, an explanatory paragraph should be included, preceding the opinion paragraph, that describes all of the substantive reasons for the auditor’s opinion and the effects on the financial statements, if readily determinable. If it is not practical to determine the effects of the departure, the explanatory paragraph should contain a statement to that effect. If information about the effects of the departure is described in the notes, the explanatory paragraph may be shortened by referring to the note.

.08 **Inadequate Disclosure.** Departures from GAAP include not just inappropriate application of accounting principles, but also omitted or inadequate disclosures in the financial statements. In such situations, the auditor should add an explanatory paragraph, preceding the opinion paragraph, that describes the nature of the inadequate or omitted disclosure and, if practical, the information that should have been disclosed. The significance of the omitted or inadequate disclosure will determine whether a qualified or adverse opinion is appropriate.
.09 Report Modification. The opinion paragraph for a qualified opinion due to a departure from GAAP should include the words except or exception and a reference to the explanatory paragraph that describes that departure. Adverse opinions should include language such as “do not present fairly” and should also include a reference to the explanatory paragraph. A qualified opinion indicating a departure from GAAP is presented in paragraph .02 of AAM section 9240. An adverse opinion indicating a departure from GAAP is presented in paragraph .01 of AAM section 9220.

Errors, Fraud, and Illegal Acts

.10 If the financial statements are materially affected by an error, fraud, or illegal act that has not been properly accounted for and disclosed, a qualified or adverse opinion may be considered. If the auditor is precluded from applying necessary procedures or from obtaining sufficient information to conclude whether an error, fraud, or illegal act that could be material to the financial statements has occurred, a qualified or disclaimer of opinion may be issued. All such matters could be discussed immediately with the engagement partner.

.11 If a client will not accept modification of the report under the circumstances above, the firm may wish to consider withdrawing from the engagement and consulting with legal counsel.

Consistency Exceptions

.12 Accounting changes affecting consistency include the following:

- A change from one generally accepted accounting principle to another method, practice or principle that is different from the one previously used
- A change from an unacceptable to an acceptable principle (correction of an error)
- A change in financial statement classification that significantly affects financial position or results of operations (for example, classification of an item in earnings from operations as other income or expense)
- A change in reporting entity

.13 Accounting changes that do not normally affect consistency include the following:

- Initial adoption of an existing accounting principle for a new event or transaction
- Insignificant reclassification
- Correction of errors not involving a principle
- Changes in accounting estimates

.14 The nature of the accounting change will determine whether prior periods should be restated or a cumulative adjustment should be included in current activities. In either event, the change should be disclosed in the notes to the financial statements and in the auditor’s report in a separate paragraph following the opinion paragraph. The auditor’s concurrence with a change is implicit unless he or she takes exception to the change. The opinion paragraph would be standard unless the change is to an unacceptable principle or method, the change is not justified, or a prospective change of a principle requiring retroactive adjustment is not discussed. In such situations, either a qualified or adverse opinion should be issued.

Uncertainties

.15 Uncertainties are significant circumstances, events, or transactions affecting the financial statements, the outcome of which cannot be reasonably estimated. Uncertainties are a particularly complex area because they can result in a qualified or adverse opinion due to a departure from GAAP, a qualified opinion, or disclaimer due to a scope limitation. Uncertainties include, but are not limited to, contingencies covered by
Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 450, Contingencies, and matters related to estimates covered by FASB ASC 275, Risks and Uncertainties.

.16 Uncertainties Not Requiring Modification of the Opinion. Paragraph .30 of AU section 508 states that when the auditor has concluded that sufficient audit evidence supports management’s assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate.

.17 Scope Limitations. If the auditor is unable to obtain sufficient audit evidence to support management’s assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. In some ways, information about uncertainties may always be considered insufficient because it is dependent on future, unknown events. However, if the auditor determines that audit evidence did or does exist, but it is unavailable to him or her (for example, because the information was destroyed or management will not allow the auditor to have access to it), the auditor may consider modifying the report for a scope limitation.

.18 Departures From GAAP. Paragraph .45 of AU section 508 describes three categories of departures from GAAP involving risks or uncertainties:

- Inadequate disclosure
- Inappropriate accounting principles
- Unreasonable accounting estimates

.19 If the auditor concludes that a matter involving a risk or uncertainty is not adequately disclosed in the financial statements in conformity with GAAP, the auditor should express a qualified or adverse opinion.

.20 Also, a departure from GAAP may exist if management has made inappropriate estimates of future events in applying accounting principles (such as the use of unreasonable expected lives of depreciable assets for calculating depreciation) or in making other accounting estimates.

.21 Going-Concern Uncertainties. If the auditor concludes that there is substantial doubt about the organization’s ability to continue as a going concern, the situation should be described in an explanatory paragraph, following the opinion paragraph. The explanatory paragraph may describe the principal events and conditions related to the going concern, their possible effects on the financial statements, management’s plans for corrective actions, and the auditor’s conclusion that substantial doubt exists. Paragraphs .12-.13 of AU section 341, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern (AICPA, Professional Standards, vol. 1), imposes the additional requirement that the explanatory paragraph include the terms substantial doubt and going concern. The auditor should not use conditional language in expressing a conclusion concerning the existence of substantial doubt about the entity’s ability to continue as a going concern in the going concern explanatory paragraph.

.22 If financial statement disclosures about the uncertainty are inadequate, a departure from GAAP exists and either a qualified or adverse opinion may be necessary.

Reporting on Supplementary Information

.23 Supplementary information includes detailed schedules of other data that are not necessary for a fair presentation of the basic financial statements. Whenever supplementary information is included in an auditor submitted document, the auditor has a responsibility to report on all of the information included in the document. A separate report on the supplementary information or a separate paragraph in the report on the basic financial statements may be used to report on supplementary information. If a separate report is issued, it may be on the firm’s letterhead and should be signed. The report date should be the same as for the basic financial statements.
.24 Reports on supplementary information should express or disclaim audit assurance. The nature of the engagement and the extent and results of testing of supplementary information will determine the firm’s responsibility in each circumstance. If a separate report on the supplemental information is issued, the first sentence of that report may refer to the report on the basic financial statements.

Reporting on a Single Statement

.25 In certain circumstances, an engagement to audit a single financial statement may be accepted. Generally these engagements, called limited reporting engagements, are a result of the client needing a single financial statement to fulfill a contractual requirement, such as an organization that must provide its landlord with an audited income statement for purposes of calculating rent. Also, entities that have never been audited often request an audit of the statement of financial position only for the first year, with the intention of having audits of the entire financial statements in the future. Generally such engagements are accepted as long as there is a legitimate reason for the limited engagement and provided that there are no restrictions on access to information underlying the financial statements or on the scope of the procedures the auditor needs to perform. In such engagements, an unqualified opinion may be expressed on the financial statement the auditor was engaged to audit. If the other financial statements are presented, a disclaimer of opinion may be issued on those statements. An unqualified opinion on a single statement audit is presented in paragraph .03 of AAM section 9210.

Relying on the Work of a Specialist

.26 The firm may engage specialists to perform certain work supporting representations in the financial statements. AU section 336, Using the Work of a Specialist (AICPA, Professional Standards, vol. 1), indicates that if a review of the specialist’s work finds it satisfactory, and if no report modification is necessary because of the specialist’s findings, the auditor should not refer to the specialist’s work.

.27 If the specialist’s work is not adequate to support the financial statement representations, a qualification or disclaimer of opinion because of a scope limitation may be appropriate. Findings of the specialist that indicate the financial statements are not in accordance with GAAP may necessitate a qualified or adverse opinion.

Lack of Independence

.28 For issuers, whenever the auditor is not independent with respect to a client whose financial statements have been audited, a disclaimer of opinion should be issued. The Public Company Accounting Oversight Board (PCAOB), through PCAOB Rule 3600T, Interim Independence Standards (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”), has provisionally designated Rule 101, Independence (AICPA, Professional Standards, vol. 2, ET sec. 101 par. .01), of the AICPA Code of Professional Conduct, and interpretations and rulings thereunder, as they existed on April 16, 2003. Independence Standards Board (ISB) Standard No. 2, Certain Independence Implications of Audits of Mutual Funds and Related Entities, ISB Standard No. 3, Employment with Audit Clients and ISB Interpretation 99-1, Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives) (AICPA, PCAOB Standards and Related Rules, PCAOB Standards, As Amended, “Independence Standards Board”), provide interim independence standards for registered public accounting firms performing audits of issuers. The PCAOB’s interim independence rules do not supersede the independence rules of the Securities and Exchange Commission (SEC). Therefore, to the extent that a provision of the SEC’s rule or policy is more restrictive—or less restrictive—than the PCAOB’s interim independence standards, a registered public accounting firm must comply with the more restrictive requirement. For nonissuers, the firm may only issue a compilation report that includes a statement that the firm is not independent.

.29 PCAOB Rule 3525, Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”), provides guidance related to the auditor’s responsibilities when seeking audit committee preapproval of internal
control related nonaudit services. The rule is intended to ensure that audit committees are provided relevant information for them to make an informed decision on how the performance of internal control-related services may affect independence. Specifically, the public accounting firm shall describe, in writing, the scope of the service and submit to the audit committee, as well as discuss with the audit committee the potential effects of the service on the firm’s independence. Issuers are also required to document the substance of such discussions in writing. The full text of this rule can be found at www.pcaob.org/Rules/Rules_of_the_Board/Rule_3525.pdf.

.30 PCAOB Rule 3526, Communication with Audit Committees Concerning Independence (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Rules”), which builds on ISB Standard No. 1, provides that before accepting a new audit engagement and annually thereafter the auditor must describe in writing to the audit committee all relationships between the auditor and the client (including affiliates of both) that reasonably could be thought to bear on independence. The auditor must also discuss these matters with the audit committee, and document the substance of that discussion. The full text of this rule can be found at www.pcaobus.org/Rules/Docket_017/2008-04-22_Release_2008-003.pdf.

Reissuance of Audit Reports as Predecessors

.31 If the auditor is asked by a former client to reissue its report on prior-period financial statements, he or she should inform the client of the procedures necessary to comply with that request. If the client agrees to perform these procedures, and pay the fee for these services, the auditor would ordinarily agree to reissue the report.

.32 Before reissuing a report, the auditor should consider whether the previous opinion on those prior period statements is still appropriate. Differences in the current form and presentation of the financial statements for the prior period, or the possibility of material subsequent events affecting those financial statements, could make the previous opinion inappropriate. The auditor should perform at least the following procedures:

- Read the financial statements of the current period.
- Compare the prior-period financial statements with the financial statements to be presented in comparative format by the successor.
- Obtain a letter of representation from the management of the former client and successor auditor. The representation letter from management of the former client should state (a) whether any information has come to management’s attention that would cause them to believe that any of the previous representations should be modified, and (b) whether any events have occurred subsequent to the balance sheet date of the latest prior period financial statements reported on by the predecessor auditor that would require adjustment to or disclosure in those financial statements. The successor should represent that his or her audit has not revealed any matters that may have a material effect on the prior period financial statements.

.33 If the firm reissues its report without change, the previous report date should be used. If the financial statements or the report of the prior period are revised, the report should be dual dated as to the event or matter causing the revision. There should be no reference to the report or the work of the successor auditor.

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Reissuance of the Audit Report Subsequent to the Date of Original Issue

.34 Occasionally the firm may be requested by a client to furnish additional copies of a previously issued report. Approval of the engagement partner may be necessary to reissue a previously issued report. In such situations, the engagement partner may prepare a memo stating the reasons for the reissuance and that he or she is not aware of any circumstances occurring since the original report date that would require adjustment to or disclosure in the financial statements.

.35 Use of the original report date removes any implication that records, transactions, or events after that date have been audited or reviewed. Although the auditor has no responsibility to make further investigation or inquiry as to subsequent events, the engagement partner may consider a brief discussion with the client’s chief financial or executive officer before reissuing his or her report.

Subsequent Discovery of Facts Existing at Report Date

.36 Although the auditor has no obligation to make any continuing inquiries or perform other procedures after issuing his or her report, the auditor may become aware of information that affects the financial statements upon which he or she has previously reported. When becoming aware of such information, the auditor should determine the reliability of the information and whether such information existed at the date of the report. The auditor should make inquiries of client management in this regard.

.37 If the information is reliable and did exist at the date of the report, if the report would have been affected if the information had been known at the report date, and if there are persons relying on the financial statements who would attach importance to the information, the auditor should take action to prevent future reliance on the report. If the engagement partner concludes that action should be taken to prevent future reliance on the report, he or she should advise the client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to the persons known to be, or likely to be, relying on the financial statements and related report. Disclosures may be made in one of the following ways:

- If the effects of subsequent facts can be promptly determined, disclosure should include reissuing revised financial statements and a revised report. The reasons for the revision usually should be described in a note to the financial statements and referred to in the auditor’s report.

- If the current financial statements have not been released, appropriate disclosure of the revision of the prior period financial statements can be included therein.

- When the effects of subsequent facts cannot be readily determined, revisions of financial statements and reports may be delayed. In this case, persons known to be, or likely to be, relying on the financial statements should be notified by the client that the financial statements and related reports should not be relied on, and that revised financial statements and report will be forthcoming.

.38 If the client refuses to make the disclosures discussed in the preceding paragraph, the auditor may wish to contact legal counsel. He or she should also notify all members of the board of directors of such refusal. The firm will take the following steps to prevent future reliance on its report:

- Notify the client that the auditor’s report must no longer be associated with the financial statements.

- Notify any applicable regulatory agencies that the report should no longer be relied upon.

- Notify each person known to be relying on the financial statements that the report should no longer be relied upon.

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5 The AICPA Auditing Standards Board Interpretation No. 1, “Eliminating a Going-Concern Explanatory Paragraph From a Reissued Report,” of AU section 341, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern (AICPA, Professional Standards, vol. 1, AU sec. 9341 par. .01–.02), provides guidance regarding situations when a previously issued report contains a going-concern explanatory paragraph, and the situation that gave rise to the going-concern has been resolved.
.39 If the auditor’s investigation of the subsequently discovered information is satisfactory, and he or she has determined that the information is reliable, the notifications in paragraph .36 should include a description of the effects of the information on the financial statements. If the client has not cooperated and, as a result, the auditor has been unable to conduct a satisfactory investigation, the auditor does not need to indicate the details of the information. Instead, the auditor can merely indicate that information has come to his or her attention that his or her client has not cooperated in attempting to substantiate, and that, if the information is true, the auditor believes that his or her report must no longer be relied upon nor should the auditor be associated with the financial statements.

[The next page is 9211.]
AAM Section 9210

Unqualified Opinions

.01 Auditor’s Standard Report—Comparative Financial Statements

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: Paragraph .08 of AU section 508, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1)]
.02 Auditor’s Standard Report—Single Year Financial Statements

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: Paragraph .08 of AU section 508]
.03 Report on a Single Statement Audit (Balance Sheet Only Presented) [Assuming the auditor is able to satisfy himself or herself regarding the consistency of application of accounting principles]

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20XX. This financial statement is the responsibility of the Company’s management. Our responsibility is to express an opinion on this financial statement based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the balance sheet is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the balance sheet. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall balance sheet presentation. We believe that our audit of the balance sheet provides a reasonable basis for our opinion.

In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 20XX, in conformity with accounting principles generally accepted in the United States of America.

[Signature]
[Date]

[Source: Paragraph .34 of AU section 508]

Note: If reporting on a single statement (for example, balance sheet only) when other financial statements are also presented, the following paragraph may be added after the opinion paragraph:

Because we were not engaged to audit the statements of income, retained earnings, and cash flows, we did not extend our auditing procedures to enable us to express an opinion on the results of operations and cash flows for the year ended December 31, 20XX. Accordingly, we express no opinion on them.
.04 Reference to Other Auditors—Successor Auditor’s Report When Predecessor’s Report (Unqualified) Is Not Presented

Independent Auditor’s Report

Addressee:

We have audited the balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, were audited by other auditors whose report dated March 31, 20X2, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: Paragraph .74 of AU section 508]

Practice Tip

(1) The successor auditor should not name the predecessor auditor in his report; however, the successor auditor may name the predecessor auditor if the predecessor auditor’s practice was acquired by, or merged with, that of the successor auditor.

[Source: Paragraph .74 footnote 29 of AU section 508]
Reference to Other Auditors in Report

Independent Auditor’s Report

Addressee:

We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets of $_______ and $________ as of December 31, 20X2 and 20X1, respectively, and total revenues of $_______ and $_______ for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: Paragraph .13 of AU section 508]
Reference to Other Auditors—Successor Auditor's Unqualified Report When Predecessor's Report That Included an Explanatory Paragraph Is Not Presented

Independent Auditor's Report

Addressee:

We have audited the balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, were audited by other auditors whose report dated March 1, 20X2, on those statements included an explanatory paragraph that described the change in the Company's method of computing depreciation discussed in Note X to the financial statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: Paragraph .74 of AU section 508]
.07 Reference to Other Auditors—Successor Auditor’s Report When Prior Year Financial Statements Have Been Restated Following Issuance of the Predecessor’s Report

Independent Auditor’s Report

Addressee:

We have audited the balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, before the restatement described in Note X, were audited by other auditors whose report dated March 31, 20X2, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We also audited the adjustments described in Note X that were applied to restate the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.¹

[Signature]

[Date]

[Source: Paragraph .74 of AU section 508]

¹ This paragraph may be added to the report when the successor auditor is engaged to audit and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the restatement adjustments.
.08 Reference to Other Auditors—Prior Year Financial Statements Restated Following a Pooling of Interests

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We previously audited and reported on the consolidated statements of income and cash flows of XYZ Company and subsidiaries for the year ended December 31, 19X1, prior to their restatement for the 19X2 pooling of interests. The contribution of XYZ Company and subsidiaries to revenues and net income represented . . . . . percent and . . . . . percent of the respective restated totals. Separate financial statements of the other companies included in the 19X1 restated consolidated statements of income and cash flows were audited and reported on separately by other auditors. We also audited the combination of the accompanying consolidated statements of income and cash flows for the year ended December 31, 19X1, after restatement for the 19X2 pooling of interests; in our opinion, such consolidated statements have been properly combined on the basis described in Note A of notes to consolidated financial statements.

[Signature]

[Date]

[Source: Paragraph .08 of AU section 508 and paragraph .16 of AU section 543, Part of Audit Performed by Other Independent Auditors (AICPA, Professional Standards, vol. 1)]

Note: This report is used when the auditor concludes that he or she cannot serve as principal auditor for the restated financial statements.
.09 Reference to Other Auditors—Successor Auditor Report When Prior Period Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, and for the year then ended were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those financial statements in their report dated March 31, 20X2.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]
[Date]

[Source: Paragraph .08 of AU section 508 and paragraph .61 of Interpretation No. 15, “Reporting as Successor Auditor When Prior-Period Audited Financial Statement Were Audited by a Predecessor Auditor Who Has Ceased Operations,” of AU section 508 (AICPA, Professional Standards, vol. 1, AU sec. 9508 par. .60–.75)]
.10 Reference to Other Auditors—Successor Auditor Report When Prior Period Financial Statements Were Audited By a Predecessor Auditor Who Has Ceased Operations Have Been Restated

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, and for the year then ended, before the restatement described in Note X, were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those financial statements in their report dated March 31, 20X2.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We also audited the adjustments described in Note X that were applied to restate the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.²

[Signature]

[Date]

[Source: Paragraph .74 of AU section 508 and paragraphs .61–.63 and .66 of Interpretation No. 15 of AU section 508]

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² This paragraph may be added to the report when the successor auditor is engaged to audit and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the restatement adjustments.
Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We have conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The 20X1 financial statements were reviewed by other accountants who have ceased operations, and their report thereon, dated March 1, 20X2, stated they were not aware of any material modifications that should be made to those statements for them to be in conformity with generally accepted accounting principles. However, a review is substantially less in scope than an audit and does not provide a basis for the expression of an opinion on the financial statements taken as a whole.

[Signature]

[Date]

[Source: Paragraph .17 of AU section 504, Association with Financial Statements (AICPA, Professional Standards, vol. 1), paragraph .74 of AU section 508, and paragraph .66 of Interpretation No. 15 of AU section 508]
.12 Reference to Other Accountants—Report on Nonpublic Entity Presented With Prior Period
Financial Statements Compiled by a Predecessor Accountant Who Has Ceased Operations

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 20X2, and the related
statements of income, retained earnings, and cash flows for the year then ended. These financial statements
are the responsibility of the Company’s management. Our responsibility is to express an opinion on these
financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of
America. Those standards require that we plan and perform the audit to obtain reasonable assurance about
whether the financial statements are free of material misstatement. An audit includes examining, on a test
basis, evidence supporting the amounts and disclosure in the financial statements. An audit also includes
assessing the accounting principles used and significant estimates made by managements, as well as
evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis
for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the
financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows
for the year then ended in conformity with accounting principles generally accepted in the United States of
America.

The 20X1 financial statements were compiled by other accountants who have ceased operations, and their
report thereon, dated February 1, 20X2, stated that they did not audit or review those financial statements and,
accordingly, express no opinion or any other form of assurance on them.

[Signature]

[Date]

[Source: Paragraph .17 of AU section 504, paragraph .74 of AU section 508, and paragraph .66 of Interpretation
No. 15 of AU section 508]
.13 Change in Accounting Principles or Method of Accounting

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentations. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note X to the financial statements, the Company changed its method of computing depreciation in 20XX.

[Signature]

[Date]

[Source: Paragraphs .08 and .17 of AU section 508]
.14 Going Concern—Uncertainty

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management’s plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[Signature]

[Date]

[Source: Paragraph .08 of AU section 508 and paragraph .13 of AU section 341, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern (AICPA, Professional Standards, vol. 1)]

Note: In a going-concern explanatory paragraph, the auditor should not use conditional language in expressing a conclusion concerning the existence of substantial doubt about the entity’s ability to continue as a going concern.
.15 Liquidation Basis of Accounting—Single Year Financial Statements

Independent Auditor’s Report

Addressee:

We have audited the statement of net assets in liquidation of XYZ Company as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2. In addition, we have audited the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X to the financial statements, the stockholders of XYZ Company approved a plan of liquidation on April 25, 20X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets in liquidation of XYZ Company as of December 31, 20X2, the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the results of its operations and its cash flows for the period from January 1, 20X2 to April 25, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described in the preceding paragraph.

[Signature]
[Date]

.16 Liquidation Basis of Accounting—Comparative Financial Statements

Independent Auditor’s Report

Addressee:

We have audited the balance sheet of XYZ Company as of December 31, 20X1, the related statements of income, retained earnings, and cash flows for the year then ended, and the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2. In addition, we have audited the statement of net assets in liquidation as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X to the financial statements, the stockholders of XYZ Company approved a plan of liquidation on April 25, 20X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company as of December 31, 20X1, the results of its operations and its cash flows for the year then ended and for the period from January 1, 20X2 to April 25, 20X2, its net assets in liquidation as of December 31, 20X2, and the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described in the preceding paragraph.

[Signature]

[Date]

[Source: Paragraph .36 of Interpretation No. 8 of AU section 508]
.17 Comparative Financial Statements—Unqualified Opinion on the Current Year’s Financial Statements With Disclaimer of Opinion on the Prior Year’s Statements of Income, Retained Earnings, and Cash Flows

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as explained in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We did not observe the taking of the physical inventory as of December 31, 20X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 20X0, enter into the determination of net income and cash flows for the year ended December 31, 20X1.

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 20X1.

In our opinion, the balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 20X2, present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the year ended December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: Paragraphs .08 and .67 of AU section 508]

Note: This report assumes that the independent auditor has been able to satisfy himself as to the consistency of application of generally accepted accounting principles.
.18 Comparator Financial Statements—Subsequent Restatement of Prior-Period Financial Statements to Conform With Generally Accepted Accounting Principles

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our report dated March 1, 20X2, we expressed an opinion that the 20X1 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles because of two departures from such principles: (1) the Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 20X1 financial statements to conform with accounting principles generally accepted in the United States of America. Accordingly, our present opinion on the 20X1 financial statements, as presented herein, is different from that expressed in our previous report.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: Paragraphs .08 and .69 of AU section 508]
Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The 20X1 financial statements were reviewed by us (other accountants) and our (their) report thereon, dated March 1, 20X2, stated we (they) were not aware of any material modifications that should be made to those statements for them to be in conformity with generally accepted accounting principles. However, a review is substantially less in scope than an audit and does not provide a basis for the expression of an opinion on the financial statements taken as a whole.

[Signature]
[Date]

[Source: Paragraph .08 of AU section 508 and paragraph .17 of AU section 504]

Notes: When unaudited financial statements are presented in comparative form with audited financial statements, the unaudited financial statements should be clearly marked to indicate their status.

When the financial statements are those of a public entity, the separate paragraph should include a disclaimer of opinion or a description of a review. (A sample of a disclaimer of opinion is provided in paragraph .21.)
Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The 20X1 financial statements were compiled by us (other accountants) and our (their) report thereon, dated March 1, 20X2, stated we (they) did not audit or review those financial statements and, accordingly, express no opinion or other form of assurance on them.

[Signature]
[Date]

[Source: Paragraph .08 of AU section 508 and paragraph .17 of AU section 504]

Note: When unaudited financial statements are presented in comparative form with audited financial statements, the unaudited financial statements should be clearly marked to indicate their status.
Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The 20X1 financial statements were not audited by us and, accordingly, we do not express an opinion on them.

[Signature]

[Date]

[Source: Paragraph .08 of AU section 508 and paragraphs .05 and .17 of AU section 504]

Notes: The preceding report illustrates a disclaimer of opinion as described in paragraphs .05 and .17 of AU section 504 when the financial statements are those of a public entity. For a nonpublic entity, see paragraphs .19–.20 in this section.

When unaudited financial statements are presented in comparative form with audited financial statements, the unaudited financial statements should be clearly marked to indicate their status.
Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheet of International Company as of December 31, 20XX and the related statements of income, retained earnings, and cash flows for the year then ended which, as described in Note X, have been prepared on the basis of accounting principles generally accepted in [name of country]. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America (and in [name of country]). U.S. standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of International Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in [name of country].

[Signature]
[Date]

[Source: Paragraph .10 of AU section 534, Reporting on Financial Statements Prepared for Use in Other Countries (AICPA, Professional Standards, vol. 1)]
Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of International Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note X to the financial statements, the Company has recorded fixed assets in excess of historical cost using appraised value as the basis for adjustment in accordance with accounting principles generally accepted in [name of country]. If the fixed assets had been recorded at historical cost, fixed assets and retained earnings would be decreased by $XXX,XXX and $XXX,XXX respectively, as of December 31, 20XX, and net income and earnings per share would be increased by $X,XXX and $X.XX respectively for the year then ended.

In our opinion, except for the effects of recording the fixed assets in excess of historical costs, discussed in the preceding paragraph, the financial statements present fairly, in all material respects, the financial position of International Company as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

(Optional Paragraph)

In our opinion, the financial statements referred to above present fairly the financial position of the International Company at December 31, 20XX, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in [name of country].

[Signature]
[Date]

[Source: Paragraphs .08 and .35–.57 of AU section 508 and paragraphs .14–.15 of AU section 534]

Note: This report does not apply to reports on financial statements of U.S. subsidiaries of foreign registrants presented in Securities and Exchange Commission (SEC) filings of foreign parent companies where the subsidiaries’ financial statements have been prepared on the basis of accounting used by the parent company.
.24 Correction of an Error, Not Involving an Accounting Principle

**Independent Auditor’s Report**

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note X to the financial statements, certain errors resulting in an understatement of previously reported expenses for the years ended December 31, 20X1 and 20X0 were discovered by the Company’s management during the current year. Accordingly, the 20X1 financial statements have been restated and an adjustment has been made to retained earnings as of January 1, 20X1 to correct the errors.

[Signature]

[Date]

[Sources: Paragraph .08 of AU section 508 and paragraph .12 of AU section 420, *Consistency of Application of Generally Accepted Accounting Principles* (AICPA, Professional Standards, vol. 1)]

Note: This report would be used when the issuance of financial statements accompanied by the auditor’s report for a subsequent period is imminent so that disclosure is not delayed (paragraph .06b) of AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report* [AICPA, Professional Standards, vol. 1)].
.25 Subsequent Event Prior to Issuance of Auditor’s Report

Independent Auditor’s Report

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note X to the financial statements, on March 1, 20X3, the Company entered into an agreement to sell Subsidiary A. This Subsidiary represents X percent of the Company’s total assets and X percent of its revenues.

[Signature]

[Date]

[Source: Paragraphs .08 and .19 of AU section 508]
.26 Reissued Report Due to Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report

Independent Auditor’s Report

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 10 to the financial statements, the Company’s 20X2 [specify account corrected] previously reported as $XX,XXX should have been $X,XXX. This discovery was made subsequent to the issuance of the financial statements. The financial statements have been restated to reflect this correction.

[Signature]

[March 31, 20X3, except for Note 10, as to which the date is April 30, 20X3]

[Sources: Paragraph .06(a) of AU section 561 and paragraph .08 of AU section 508]
.27 Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheet of XYZ Company as of December 31, 20X4, and the related statements of income and retained earnings and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company as of December 31, 20X4, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]


Note: The additional language related to internal control should not be used when reporting on the audit of financial statements of a nonissuer that engages its auditor to examine (or audit) and report on the effectiveness of internal control over financial reporting either voluntarily or to comply with regulatory requirements.
.28 Reference to Public Company Accounting Oversight Board Standards in an Audit Report on a Nonissuer

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheet of XYZ Company as of December 31, 20X4, and the related statements of income and retained earnings and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company as of December 31, 20X4, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]
[Date]

[Source: Paragraph .92 of Interpretation No. 18, “Reference to PCAOB Standards in an Audit Report on a Nonissuer,” of AU section 508 (AICPA, Professional Standards, vol. 1, AU sec. 9508 par. .89–.92)]

Note: This example includes the illustrative language from paragraph .88 of AU section 9508. Because the Public Company Accounting Oversight Board’s (PCAOB) Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting that is Integrated With An Audit of Financial Statements (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”), requires an audit of internal control for those entities that are subject to Section 404(a) of the act, an audit of a nonissuer performed under PCAOB auditing standards does not require an audit of internal control unless otherwise required by a regulator with jurisdiction over the nonissuer. The additional language related to internal control should not be used when reporting on the audit of financial statements of a nonissuer that engages its auditor to examine (or audit) and report on the effectiveness of internal control over financial reporting either voluntarily or to comply with regulatory requirements.

[The next page is 9271.]
AAM Section 9220

Adverse Opinions

.01 Departures from GAAP

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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

Because of the departures from accounting principles generally accepted in the United States of America identified above, as of December 31, 20X2 and 20X1, inventories have been increased $_______ and $_______ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is carried at $_______ and $_______ in excess of an amount based on the cost to the Company; and deferred income taxes of $_______ and $_______ have not been recorded; resulting in an increase of $_______ and $_______ in retained earnings and in appraisal surplus of $_______ and $_______, respectively. For the years ended December 31, 20X2 and 20X1, cost of goods sold has been increased $_______ and $_______, respectively, because of the effects of the depreciation accounting referred to above and deferred income taxes of $_______ and $_______ have not been provided, resulting in an increase in net income of $_______ and $_______, respectively.
In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of X Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows for the years then ended.

[Signature]

[Date]

[Source: Paragraph .60 of AU section 508, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1)]

[The next page is 9321.]
AAM Section 9230

Disclaimers of Opinion

.01 Beginning Inventory Not Observed (First Examination)

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.¹

Except as discussed in the following paragraph, we conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Because we were not engaged as auditors until after December 31, 20X1, we were not present to observe the physical inventory taken at that date and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities. Accordingly, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying statements of income, retained earnings and cash flows for the year ended December 31, 20X2.

In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: Paragraph .26 of AU section 508, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1)]

¹ Although the introductory paragraph of the standard disclaimer of opinion begins with “We were engaged to audit ...” and the scope paragraph of the report is omitted, paragraph .67 of AU section 508, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1), shows that the introductory paragraph does not need to be modified nor does the scope paragraph need to be omitted when the disclaimed financial statements are with audited financial statements.
.02 Inability to Obtain Sufficient Competent Evidential Matter Due to a Scope Limitation

Independent Auditor’s Report

Addressee:

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management.²

[Second paragraph of standard report should be omitted]

The Company did not make a count of its physical inventory in 20X2 or 20X1, stated in the accompanying financial statements at $_______ as of December 31, 20X2, and at $_______ as of December 31, 20X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 20X1, is no longer available. The Company’s records do not permit the application of other auditing procedures to inventories or property and equipment.

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

[Signature]
[Date]

[Source: Paragraph .63 of AU section 508]

² The wording in the first paragraph of the auditor’s standard report is changed in a disclaimer of opinion because of a scope limitation. The first sentence now states that “we were engaged to audit” rather than “we have audited” since, because of the scope limitation, the auditor was not able to perform an audit in accordance with generally accepted auditing standards. In addition, the last sentence of the first paragraph is also deleted, because of the scope limitation, to eliminate the reference to the auditor’s responsibility to express an opinion.
Independent Auditor’s Report

Addressee:

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_______ and $_______, long-term debt by $_______ and $_______, and retained earnings by $_______ and $_______ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by $_______ and $_______ and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the years then ended.

The Company did not make a count of its physical inventory in 20X2 or 20X1, stated in the accompanying financial statements at $_______ as of December 31, 20X2, and at $_______ as of December 31, 20X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 20X1, is no longer available. The Company’s records do not permit the application of other auditing procedures to inventories or property and equipment.

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

[Signature]

[Date]

[Source: Paragraphs .39 and .63 of AU section 508]

Note:

This report would be used if the generally accepted accounting principles departure is not so material to require an adverse opinion. See paragraph .01 of AAM section 9220 for an example of an adverse opinion.

[The next page is 9371.]
AAM Section 9240

Qualified Opinions

.01 Scope Limitation—Investment in Foreign Affiliate (Assuming Effects Are Such That Qualification Rather Than Disclaimer Is Appropriate)

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain audited financial statements supporting the Company’s investment in a foreign affiliate stated at $_______ and $_______ at December 31, 20X2 and 20X1, respectively, or its equity in earnings of that affiliate of $_______ and $_______, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: Paragraph .26 of AU section 508, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1)]
Independent Auditor’s Report

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_______ and $_______, long-term debt by $_______ and $_______, and retained earnings by $_______ and $_______ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by $_______ and $_______ and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]
[Date]

[Source: Paragraph .39 of AU section 508]
.03 Departure From GAAP—Leases Not Capitalized—Pertinent Facts Disclosed in Note

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accompanying balance sheets. In our opinion, accounting principles generally accepted in the United States of America require that such obligations be included in the balance sheets.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: Paragraph .40 of AU section 508]
.04 Inadequate Disclosure—Omission of Disclosures

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The Company’s financial statements do not disclose [describe the nature of the omitted information that it is not practicable to present in the auditor’s report]. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: Paragraph .42 of AU section 508]

Note:

This report assumes the effects are such that the auditor has concluded an adverse opinion is not appropriate.
.05 Inadequate Disclosure—Omission of Statement of Cash Flows

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income and retained earnings for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Company declined to present a statement of cash flows for the years ended December 31, 20X2 and 20X1. Presentation of such statement summarizing the Company’s operating, investing, and financing activities is required by accounting principles generally accepted in the United States of America.

In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: Paragraph .44 of AU section 508]
.06 Change in Accounting Principle Without Reasonable Justification

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As disclosed in Note X to the financial statements, the Company adopted, in 20X2, the first-in, first-out method of accounting for its inventories, whereas it previously used the last-in, first-out method. Although use of the first-in, first-out method is in conformity with accounting principles generally accepted in the United States of America, in our opinion the Company has not provided reasonable justification for making this change as required by those principles.

In our opinion, except for the change in accounting principle discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: Paragraph .52 of AU section 508]

Note:

If the change was from an accounting principle that is not generally accepted to one that is generally accepted it would be a correction of an error and would require recognition in the auditor’s report as to consistency. However, because the middle paragraph contains all of the information required in an explanatory paragraph (following the opinion paragraph) as required by paragraph .16–.18 of AU section 508, an explanatory paragraph is not required in this instance.
Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The company previously recorded its land at cost but adjusted the amounts to appraised values during the year, with a corresponding increase in stockholders’ equity in the amount of $_____. In our opinion, the new basis on which land is recorded is not in conformity with accounting principles generally accepted in the United States of America.

In our opinion, except for the change to recording appraised values as described above, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: Paragraph .55 of AU section 508]
More than One Reason—Qualified Opinion on Prior Year’s Financial Statements With the Current Year Qualified for the Same Reason and an Additional Reason

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain audited financial statements supporting the Company’s investment in a foreign affiliate stated at $_______ and $_______ at December 31, 20X2 and 20X1, respectively, or its equity in earnings of that affiliate of $_______ and $_______, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

The Company has excluded, from property and debt in the accompanying 20X2 balance sheet, certain lease obligations that were entered into in 20X2, which in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $____, long-term debt by $____, and retained earnings by $____, as of December 31, 20X2. Additionally, net income would be increased (decreased) by $____ and earnings per share would be increased (decreased) by $____ for the year then ended.

In our opinion, except for the effects on the 20X2 and 20X1 financial statements of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, and except for the effects of the 20X2 financial statements of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]
[Date]

[Source: Paragraphs .26 and .39 of AU section 508]
AAM Section 9245

Information Accompanying Audited Financial Statements

.01 Omission of Supplementary Information Required by the Financial Accounting Standards Board (FASB)

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Company has not presented [describe the supplementary information required by generally accepted accounting principles (GAAP)¹] that accounting principles generally accepted in the United States has determined is necessary to supplement, although not required to be part of, the basic financial statements.

[Signature]

[Date]

[Source: Paragraph .08 of AU section 558, Required Supplementary Information (AICPA, Professional Standards, vol. 1)]

¹ The auditor may identify the body requiring the information, such as the Financial Accounting Standards Board (FASB) in this example.
Independent Auditor’s Report

Addressee:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City’s basic financial statements as listed in the table of contents. These financial statements are the responsibility of the City of Example’s management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City’s internal control over financial reporting. Accordingly, we express no such opinion.] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position, and, where applicable, cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The City of Example, Any State, has not presented [describe the supplementary information required by GAAP] that accounting principles generally accepted in the United States of America require to supplement, although not to be part of, the basic financial statements.

[Signature]

[Date]

[Sources: Paragraph .08 of AU section 558; AICPA Audit and Accounting Guide State and Local Governments, updated as of March 1, 2009, paragraph 14.56]
.03 Material Departures From FASB Guidelines for Required Supplementary Information

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The [specifically identify the supplementary information] on page XX is not required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. As result of such limited procedures, we believe that the [specifically identify the supplementary information] is not in conformity with accounting principles generally accepted in the United States because [describe the material departure(s) from the GAAP4 guidelines].

[Signature]
[Date]

[Source: Paragraph .08 of AU section 558]

Note: Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by GAAP. However, management may choose not to place the required supplementary information outside the basic financial statements. In such circumstances, unless it is audited as part of the basic financial statements, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor’s report on the audited financial statements should be expanded to include a disclaimer on the supplementary information.

[Source: Paragraph .11 of AU section 558] (See paragraph .10 of this section.)

4 The auditor may identify the body requiring the information, such as the FASB in this example.
.04 Material Departures From GASB Guidelines for Required Supplementary Information

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City’s basic financial statements as listed in the table of contents. These financial statements are the responsibility of the City of Example’s management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City’s internal control over financial reporting. Accordingly, we express no such opinion.] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position, and, where applicable, cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The [specifically identify the supplementary information] on pages XX through XX and XX through XX are not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. As a result of such limited procedures, we believe that the [specifically identify the supplementary information] is not in conformity with accounting principles generally accepted in the United States because [describe the material departure(s) from GAAP].

[Signature]

[Date]

[Sources: Paragraph .08 of AU section 558; AICPA Audit and Accounting Guide State and Local Governments, updated as of March 1, 2009, paragraph 14.79 (appendix A example A-1)]

Note: GASB standards require the management’s discussion and analysis, which is required supplementary information (RSI), to precede the basic financial statements and most other RSI to be presented immediately following the notes to the financial statements. Although paragraph .11 of AU section 558 discusses alternative placement of RSI provided it is clearly marked as unaudited, that alternative is not available for GASB-required supplementary information given the GASB’s specific requirements for placement. If a government does not place GASB-required supplementary information in

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5 This optional wording may be added in accordance with Interpretation No. 17 of AU section 508, which provides reporting guidance for audits of nonissuers. If this optional wording is added, the remainder of the paragraph would read as follows:

An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

6 The auditor may identify the body requiring the information, such as the GASB in this example.
its financial report as required by GASB standards, the auditor should consider the effect of the placement on his or her report. Specifically, the auditor should consider whether to report that the RSI placement constitutes a presentation that departs materially from prescribed guidelines.

[Source: AICPA Audit and Accounting Guide State and Local Governments, updated as of March 1, 2009, paragraph 2.59]
.05 Prescribed Procedures Not Completed Regarding Supplementary Information Required by the FASB

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The [specifically identify the supplementary information] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. Further, we were unable to apply to the information certain procedures prescribed by professional standards because [state the reasons].

[Signature]
[Date]

[Source: Paragraph .08 of AU section 558]

Notes: Even though the auditor is unable to complete the prescribed procedures, if, on a basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she should describe the nature of any material departure(s) in the report. [Source: Paragraph .08 of AU section 558]

Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by GAAP. However, management may choose not to place the required supplementary information outside of the basic financial statements. In such circumstances, unless it is audited as part of the basic financial statements, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor’s report should be expanded to include a disclaimer on the supplementary information. [Source: Paragraph .11 of AU section 558] (See paragraph .10 in this section.)
Independent Auditor’s Report

Addressee:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City’s basic financial statements as listed in the table of contents. These financial statements are the responsibility of the City of Example’s management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City’s internal control over financial reporting. Accordingly, we express no such opinion.] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position, and, where applicable, cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The [specifically identify the supplementary information] on pages XX through XX and XX through XX are not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. Further, we were unable to apply to the information certain procedures prescribed by professional standards because [state the reasons].

[Signature]

[Date]

[Sources: Paragraph .08 of AU section 558; AICPA Audit and Accounting Guide State and Local Governments, updated as of March 1, 2009, paragraph 14.79, (appendix A example A-1)]

Notes: Even though the auditor is unable to complete the prescribed procedures, if, on the basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she should describe the nature of any material departure(s) in the report. [Source: Paragraph .08 of AU section 558]

GASB standards require the management’s discussion and analysis, which is RSI, to precede the basic financial statements and most other RSI to be presented immediately following the notes to the financial statements. Although paragraph .11 of AU section 558 discusses alternative placement of RSI

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7 This optional wording may be added in accordance with Interpretation No. 17 of AU section 508, which provides reporting guidance for audits of nonissuers. If this optional wording is added, the remainder of the paragraph would read as follows:

An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.
provided it is clearly marked as unaudited, that alternative is not available for GASB-required supplementary information given the GASB’s specific requirements for placement. If a government does not place GASB-required supplementary information in its financial report as required by GASB standards, the auditor should consider the effect of the placement on his or her report. Specifically, the auditor should consider whether to report that the RSI placement constitutes a presentation that departs materially from prescribed guidelines. [Source: AICPA Audit and Accounting Guide State and Local Governments, updated as of March 1, 2009, paragraph 2.59]
.07 Unresolved Doubts About Adherence to Guidelines Regarding Supplementary Information Required by FASB

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The [specifically identify the supplementary information] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by accounting principles generally accepted in the United States. [The auditor should consider including in the report the reason(s) he or she was unable to resolve his or her substantial doubts.]

[Signature]
[Date]

[Source: Paragraph .08 of AU section 558]

Note: Even though the auditor is unable to complete the prescribed procedures, if, on the basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she should describe the nature of any material departure(s) in the report.

[Source: Paragraph .08 of AU section 558]

Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by GAAP. However, management may choose not to place the required supplementary information outside of the basic financial statements. In such circumstances, unless it is audited as part of the basic financial statements, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor’s report should be expanded to include a disclaimer on the supplementary information.

[Source: Paragraph .11 of AU section 558] (See paragraph .10 in this section.)
Independent Auditor’s Report

Addressee:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City’s basic financial statements as listed in the table of contents. These financial statements are the responsibility of the City of Example’s management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City’s internal control over financial reporting. Accordingly, we express no such opinion.]

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position, and, where applicable, cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The [specifically identify the supplementary information] on pages XX through XX and XX through XX are not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by accounting principles generally accepted in the United States. [The auditor should consider including in the report the reason(s) he or she was unable to resolve his or her substantial doubts.]

[Signature]

[Date]

[Sources: Paragraph .08 of AU section 558; AICPA Audit and Accounting Guide State and Local Governments, updated as of March 1, 2009, paragraph 14.79 (appendix A example A-1)]

Notes: Even though the auditor is unable to complete the prescribed procedures, if, on the basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she should describe the nature of any material departure(s) in the report. [Source: Paragraph .08 of AU section 558]

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8 This optional wording may be added in accordance with Interpretation No. 17 of AU section 508, which provides reporting guidance for audits of nonissuers. If this optional wording is added, the remainder of the paragraph would read as follows:

An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.
GASB standards require the management’s discussion and analysis, which is RSI, to precede the basic financial statements and most other RSI to be presented immediately following the notes to the financial statements. Although paragraph .11 of AU section 558 discusses alternative placement of RSI provided it is clearly marked as unaudited, that alternative is not available for GASB-required supplementary information given the GASB’s specific requirements for placement. If a government does not place GASB-required supplementary information in its financial report as required by GASB standards, the auditor should consider the effect of the placement on his or her report. Specifically, the auditor should consider whether to report that the RSI placement constitutes a presentation that departs materially from prescribed guidelines.

[Source: AICPA Audit and Accounting Guide State and Local Governments, updated as of March 1, 2009, paragraph 2.59.]
.09 Report on Accompanying Information

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The (identify accompanying information) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature]

[Date]

[Source: Paragraph .12 of AU section 551, Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents (AICPA, Professional Standards, vol. 1)]

Note: The report on the accompanying information may be added to the auditor’s standard report on the basic financial statements or may appear separately in the auditor-submitted document.

[Source: Paragraph .06 of AU section 551]
.10 Disclaimer on Accompanying Information (Not Audited)

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The [identify the accompanying information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

[Signature]

[Date]

[Source: Paragraph .13 of AU section 551]

Notes: The report on the accompanying information may be added to the auditor’s standard report on the basic financial statements or may appear separately in the auditor-submitted document.

[Source: Paragraph .06 of AU section 551]

When the auditor disclaims an opinion on all or part of the accompanying information in a document that he or she submits to his or her client or to others, such information should either be marked as unaudited or should include a reference to the auditor’s disclaimer of opinion. The wording of the disclaimer will vary according to the circumstances.

[Source: Paragraph .13 of AU section 551]
.11 Disclaimer on Part of the Accompanying Information (Not Audited)

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information on pages XX-YY is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information, except for that portion marked “unaudited,” on which we express no opinion, has been subjected to the auditing procedures applied in the audit of the basic financial statements; and, in our opinion, the information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature]

[Date]

[Source: Paragraph .13 of AU section 551]

Notes: The report on the accompanying information may be added to the auditor’s standard report on the basic financial statements or may appear separately in the auditor-submitted document.

[Source: Paragraph .06 of AU section 551]

When the auditor disclaims an opinion on all or part of the accompanying information in a document that he or she submits to his or her client or to others, such information should either be marked as unaudited or should include a reference to the auditor’s disclaimer of opinion. The wording of the disclaimer will vary according to the circumstances.

[Source: Paragraph .13 of AU section 551]
.12 Qualification on Basic Financial Statements and Accompanying Information (Departure From GAAP)

Independent Auditor’s Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_______ and $_______, long-term debt by $_______ and $_______, and retained earnings by $_______ and $_______ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by $_______ and $_______ and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The schedules of property and related depreciation (page X), and long-term debt with related interest (page Y), as of December 31, 20X2, are presented for purposes of additional analysis and are not a required part of the basic financial statements. The information in such schedules has been subjected to the auditing procedures applied in the audit of the basic financial statements; and, in our opinion, except for the effects on the schedule of property of not capitalizing certain lease obligations as explained in the third paragraph of this report, such information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature]
[Date]

[Sources: Paragraph .14 of AU section 551 and paragraph .39 of AU section 508, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1)]

Note: The report on the accompanying information may be added to the auditor’s standard report on the basic financial statements or may appear separately in the auditor-submitted document.

[Source: Paragraph .06 of AU section 551]
.13 Supplementary Information Required by the FASB Included in Auditor-Submitted Document

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The [identify the supplementary information] on page XX is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

[Signature]

[Date]

[Source: Paragraph .15 of AU section 551]

Notes: The report on the accompanying information may be added to the auditor’s standard report on the basic financial statements or may appear separately in the auditor-submitted document. [Source: Paragraph .06 of AU section 551]

When supplementary information required by GAAP is presented outside the basic financial statements in an auditor-submitted document, the auditor should (a) express an opinion on the information if the auditor has been engaged to examine the information, (b) report on the information using the guidance in paragraphs .12 and .14 of AU section 551, provided such information has been subjected to the auditing procedures applied in the audit of the basic financial statements, or (c) disclaim an opinion on the information. [Source: Paragraph .15 of AU section 551]

In certain circumstances, the auditor’s report should be expanded in accordance with paragraphs .08–.09 of AU section 558. The illustrative reports at paragraphs .01–.08 in this section are assembled from illustrative reporting language in paragraph .08 of AU section 558.

* The auditor may identify the body requiring the information, such as the FASB in this example.
.14 Supplementary Information Required by the GASB Included in Auditor-Submitted Documents

**Independent Auditor's Report**

Addressee:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the City of Example’s management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City’s internal control over financial reporting. Accordingly, we express no such opinion.] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position, and, where applicable, cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The [identify accompanying required supplementary information] on pages XX through XX and XX through XX are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

[Signature]
[Date]

[Sources: Paragraph .15 of AU section 551; AICPA Audit and Accounting Guide State and Local Governments, updated as of March 1, 2009, paragraph 14.79 (appendix A example A-1)]

**Notes:** The report on the accompanying information may be added to the auditor’s standard report on the basic financial statements or may appear separately in auditor-submitted documents. [Source: Paragraph .06 of AU section 551]

When supplementary information required by GAAP is presented outside the basic financial statements in an auditor-submitted document, the auditor should (a) express an opinion on the information if the auditor has been engaged to examine the information, (b) report on the information using the guidance in paragraphs .12 and .14 of AU section 551), provided such information has been

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10 This optional wording may be added in accordance with Interpretation No. 17 of AU section 508, which provides reporting guidance for audits of nonissuers. If this optional wording is added, the remainder of the paragraph would read as follows:

An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

11 The auditor may identify the body requiring the information, such as the GASB in this example.
subjected to the auditing procedures applied in the audit of the basic financial statements, or (c) disclaim an opinion on the information.

In certain circumstances, the auditor’s report should be expanded in accordance with paragraphs .08–.09 of AU section 558. The illustrative reports at paragraphs .01–.08 in this section are assembled from illustrative reporting language in paragraph .08 of AU section 558 and the AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2009.
.15 Consolidating Information Not Separately Audited

Independent Auditor’s Report

Addressee:

We have audited the accompanying consolidated balance sheets of X Company and subsidiaries as of December 31, 20X2 and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of X Company and subsidiaries as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual companies. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

[Signature]

[Date]

[Source: Paragraph .18 of AU section 551]

Notes: The report on the consolidating information may be added to the auditor’s standard report on the basic financial statements or may appear separately in the auditor-submitted document.

When the auditor is engaged to express an opinion only on the consolidated financial statements and consolidating information is also included, the auditor should be satisfied that the consolidating information is suitably identified. For example, when the consolidated financial statements include columns of information about the components of the consolidated group, the balance sheets might be titled, “Consolidated Balance Sheet-December 31, 20X1, with Consolidating Information,” and the columns including the consolidating information might be marked, “Consolidating Information.” When the consolidating information is presented in separate schedules, the schedules presenting balance sheet information of the components might be titled, for example, “Consolidating Schedule, Balance Sheet Information, December 31, 20X1.”

[Source: Paragraph .18 of AU section 551]
Independent Auditor’s Report

Addressee:

We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 19X5 and 19X4, and the related consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 19X5. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provided a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the ABC Company and subsidiaries as of December 31, 20X5 and 20X4, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 20X5, in conformity with accounting principles generally accepted in the United States of America.

We have also previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheets as of December 31, 20X3, 20X2, and 20X1, and the related statements of income, retained earnings, and cash flows for the years ended December 31, 20X2, and 20X1 (none of which are presented herein); and we expressed unqualified opinions on those consolidated financial statements. In our opinion, the information set forth in the selected financial data for each of the five years in the period ended December 31, 20X5, appearing on page xx, is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

[Signature]

[Date]

[Source: Paragraph .10 of AU section 552, Reporting on Condensed Financial Statements and Selected Financial Data (AICPA, Professional Standards, vol. 1)]

[The next page is 9471.]
AAM Section 9250

Engagements to Report on Internal Control

.01 Auditor’s Report When Expressing an Unqualified Opinion Directly on an Entity’s Internal Control Over Financial Reporting as of a Specified Date

Independent Auditor’s Report

We have examined W Company’s internal control over financial reporting as of December 31, 20XX, based on [identify criteria].1 W Company’s management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [title of management’s report]. Our responsibility is to express an opinion on W Company’s internal control over financial reporting based on our examination.

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our examination included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our examination also included performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

An entity’s internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]. An entity’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity’s assets that could have a material effect on the financial statements.2

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the

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1 For example, “criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).”

2 When the auditor has been engaged to examine and report on the internal control over financial reporting for an insured depository institution that is a bank (which is not subject to Section 404 of the Sarbanes-Oxley Act of 2002) that has elected to report on controls for purposes of Section 112 of the Federal Deposit Insurance Corporation Improvement Act at the bank holding company level, the following wording may replace the standard definition paragraph wording:

An entity’s internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America. Because management’s assessment and our examination were conducted to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), our examination of [Holding Company’s] internal control over financial reporting included controls over the preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and with the instructions to the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C). An entity’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity’s assets that could have a material effect on the financial statements.
risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [identify criteria].

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [identify financial statements] of W Company and our report dated [date of report, which should be the same as the date of the report on the examination of internal control] expressed [include nature of opinion].

[Signature]

[Date]


.02 Auditor’s Report When Expressing an Unqualified Opinion on a Written Assertion About an Entity’s Internal Control Over Financial Reporting as of a Specified Date

Independent Auditor’s Report

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, 20XX based on [identify criteria]. W Company’s management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [title of management report]. Our responsibility is to express an opinion on management’s assertion based on our examination.

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our examination included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our examination also included performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

An entity’s internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]. An entity’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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3 For example, “criteria established in Internal Control—Integrated Framework issued by COSO.”
In our opinion, management’s assertion that W Company maintained effective internal control over financial reporting as of December 31, 20XX is fairly stated, in all material respects, based on [identify criteria].

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [identify financial statements] of W Company and our report dated [date of report, which should be the same as the date of the report on the examination of internal control] expressed [include nature of opinion].

[Signature]

[Date]

[Source: Example 2 in paragraph .169 of AT section 501]

.03 Adverse Opinion on Internal Control When a Material Weakness in Internal Control Exists as of a Specified Date

Independent Auditor’s Report

We have examined W Company’s internal control over financial reporting as of December 31, 20XX, based on [identify criteria]. W Company’s management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [title of management’s report]. Our responsibility is to express an opinion on W Company’s internal control over financial reporting based on our examination.

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our examination included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our examination also included performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

An entity’s internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]. An entity’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis. The following material weakness has been identified and included in the accompanying [title of management’s report].

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4 For example, “criteria established in Internal Control—Integrated Framework issued by COSO.”

AICPA Audit and Accounting Manual
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, 20XX, based on [identify criteria].

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [identify financial statements] of W Company. We considered the material weakness identified above in determining the nature, timing, and extent of audit tests applied in our audit of the 20XX financial statements, and this report does not affect our report dated [date of report, which should be the same as the date of the report on the examination of internal control], which expressed [include nature of opinion].

[Signature]

[Date]

[Source: Example 3 in paragraph .169 of AT section 501]

.04 Disclaimer of Opinion When Restrictions That Significantly Limit the Scope of the Examination Are Imposed by the Client or the Responsible Party

Independent Auditor’s Report

We were engaged to examine W Company’s internal control over financial reporting as of December 31, 20XX, based on [identify criteria]. W Company’s management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [title of management’s report].

[Paragraph that describes the substantive reasons for the scope limitation] Accordingly, we were unable to perform auditing procedures necessary to form an opinion on W Company’s internal control over financial reporting as of December 31, 20XX.

Because of the limitation on the scope of our audit described in the paragraph above, 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 W Company’s internal control over financial reporting.

[Signature]

[Date]

[Source: Paragraph .118 and example 4 in paragraph .169 of AT section 501]

.05 Disclaimer of Opinion When Restrictions That Significantly Limit the Scope of the Examination Are Imposed by the Client or the Responsible Party and the Limited Procedures Performed by the Auditor Caused the Auditor to Conclude That One or More Material Weaknesses Exist

Independent Auditor’s Report

We were engaged to examine W Company’s internal control over financial reporting as of December 31, 20XX, based on [identify criteria]. W Company’s management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [title of management’s report].

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5 The auditor’s report need only refer to the material weaknesses described in management’s report and need not include a description of each material weakness, provided each material weakness is included and fairly presented in all material respects in management’s report. Paragraphs .111–.114 of AT section 501, An Examination of an Entity’s Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements (AICPA, Professional Standards, vol. 1), establishes standards and provides guidance regarding reporting adverse opinions.

6 For example, “criteria established in Internal Control—Integrated Framework issued by COSO.”

7 For example, “criteria established in Internal Control—Integrated Framework issued by COSO.”
Accordingly, we were unable to perform auditing procedures necessary to form an opinion on W Company’s internal control over financial reporting as of December 31, 20XX.

An entity’s internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]. An entity’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity’s assets that could have a material effect on the financial statements.

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 the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis. The following material weakness has been identified and included in the accompanying [title of management’s report].

[Identify the material weakness described in management’s report and include a description of the material weaknesses, including its nature and its actual and potential effect on the presentation of the entity’s financial statements issued during the existence of the material weakness]

Because of the limitation on the scope of our audit described in the paragraph above, 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 W Company’s internal control over financial reporting.

We have audited, in accordance with auditing standards generally accepted in the United States of America, the [identify financial statements] of W Company and our report dated [date of report] expressed [include nature of opinion]. We considered the material weakness identified above in determining the nature, timing, and extent of audit tests applied in our audit of the 20XX financial statements, and this report does not affect such report on the financial statements.

[Signature]

[Date]

[Source: Paragraphs .118–.119 and example 4 in paragraph .169 of AT section 501]
effectiveness of internal control over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 percent and 30 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 20XX. The effectiveness of B Company’s internal control over financial reporting was examined by other auditors 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 auditors.

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our examination included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our examination also included performing such other procedures as we considered necessary in the circumstances. We believe that our examination and the report of the other auditors provide a reasonable basis for our opinion.

An entity’s internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with applicable financial reporting framework, such as accounting principles generally accepted in the United States of America. An entity’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with applicable financial reporting framework, such as accounting principles generally accepted in the United States of America, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, based on our examination and the report of the other auditors, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [identify criteria].

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [identify financial statements] of W Company and our report dated [date of report, which should be the same as the date of the report on the examination of internal control] expressed [include nature of opinion].

[Signature]

[Date]

[Source: Example 5 in paragraph .169 of AT section 501]

.07 Unqualified Opinion About the Suitability of Design of the Entity’s Internal Control

Independent Auditor’s Report

We have examined the suitability of W Company’s design of internal control over financial reporting to prevent or detect and correct material misstatements in its financial statements on a timely basis as of December 31, 20XX, based on [identify criteria]. W Company’s management is responsible for the suitable

9 Whether the other practitioner’s opinion is expressed on the responsible party’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.
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. 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, 20XX, and, accordingly, we express no opinion on operating effectiveness.

Because of its inherent, internal control, over financial reporting may not prevent or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, W Company’s internal control over financial reporting was suitably designed, in all material respects, to prevent or detect and correct material misstatements in the financial statements on a timely basis as of December 31, 20XX, based on [identify criteria].

[Signature]

[Date]


Notes:

This report assumes that the control criteria of the regulatory agency are both suitable and available to users as discussed in paragraphs .23–.34 of AT section 101. Therefore, there is no restriction on the use of this report.

.08 Auditor’s Combined Report When Expressing an Unqualified Opinion on an Entity’s Internal Control and on the Financial Statements as of a Specified Date

Independent Auditor’s Report

We have audited the accompanying balance sheet of W Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. We also have audited W Company’s internal control over financial reporting as of December 31, 20XX, based on [identify criteria].11 W Company’s management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [title of management’s report]. Our responsibility is to express an opinion on these financial statements and an opinion on W Company’s internal control over financial reporting based on our audits.

We conducted our audit of the financial statements in accordance with auditing standards generally accepted in the United States of America and our audit of internal control over financial reporting in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial

10 Because the examination of internal control is integrated with the audit of the financial statements and an examination provides the same level of assurance as an audit, the auditor may refer to the examination of internal control as an audit in his or her report or other communications.

11 For example, “criteria established in Internal Control—Integrated Framework issued by COSO.”
statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

An entity’s internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with applicable financial reporting framework, such as accounting principles generally accepted in the United States of America. An entity’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with applicable financial reporting framework, such as accounting principles generally accepted in the United States of America, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [identify criteria].

[Signature]

[Date]

[Source: Example 6 in paragraph .169 of AT section 501]

.09 Communication of Significant Deficiencies and Material Weaknesses

In connection with our audit of W Company’s (the “Company”) financial statements as of December 31, 20XX and for the year then ended, and our audit of the Company’s internal control over financial reporting as of December 31, 20XX (“integrated audit”), the standards established by the American Institute of Certified Public Accountants require that we advise you of the following internal control matters identified during our integrated audit.

Our responsibility is to plan and perform our integrated audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether effective internal control over financial reporting was maintained in all material respects (that is, whether material weaknesses exist as of the date specified in management’s assertion). The integrated audit is not designed to detect deficiencies that, individually or in combination, are less severe than a material weakness. However, we are responsible for communicating to management and those charged with governance significant deficiencies and material weaknesses identified during the integrated audit. We are also responsible for communicating to management deficiencies that are of a lesser magnitude than a significant deficiency, unless previously communicated, and inform those charged with governance when such a communication was made.

A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. [A material weakness is a deficiency, or a combination of
deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company’s financial statements will not be prevented, or detected and corrected on a timely basis. We believe the following deficiencies constitute material weaknesses:

[Describe the material weaknesses that were identified during the integrated audit. The auditor may separately identify those material weaknesses that exist as of the date of management’s assertion by referring to the auditor’s report.]

[A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiencies to be significant deficiencies:]

[Describe the significant deficiencies that were identified during the integrated audit.]

This communication is intended solely for the information and use of management, [identify the body or individuals charged with governance], others within the organization, and [identify any specified governmental authorities] and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: Paragraph .170 of AT section 501]

.10 Communication of Internal Control Matters Noted in an Audit

Addressee:

In planning and performing our audit of the financial statements of ABC Company as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered ABC Company’s internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control. Accordingly, we do not express an opinion on the effectiveness of the Company’s internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies [and other deficiencies that we consider to be material weaknesses].

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity’s ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity’s financial statements that is more than inconsequential will not be prevented or detected by the entity’s internal control. We consider the following deficiencies to be significant deficiencies in internal control:

[Describe the significant deficiencies that were identified.]

[A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity’s internal control. We believe that the following deficiencies constitute material weaknesses.]

[Describe the material weaknesses that were identified.]

This communication is intended solely for the information and use of management, [identify the body or individuals charged with governance], others within the organization, and [identify any specified governmental authorities] and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]
[Date]

The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.

[Source: Paragraphs .26 and .29 of AU section 325A, Communicating Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, vol. 1)]

.11 Communication of Internal Control Related Matters Noted in an Audit When the Auditor Has Not Identified Any Material Weaknesses and Wishes to Communicate That to Management and Those Charged With Governance

Addressee:

In planning and performing our audit of the financial statements of ABC Company as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered ABC Company’s internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control. Accordingly, we do not express an opinion on the effectiveness of the Company’s internal control.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity’s ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity’s financial statements that is more than inconsequential will not be prevented or detected by the entity’s internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity’s internal control.

Our consideration of internal control was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above.

This communication is intended solely for the information and use of management, [identify the body or individuals charged with governance], others within the organization, and [identify any specified governmental authorities] and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.

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12 In October 2008, the Auditing Standards Board issued Statement on Auditing Standards (SAS) No. 115, Communicating Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, vol. 1, AU sec. 325). SAS No. 115 supersedes SAS No. 112, Communicating Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, vol. 1, AU sec. 325A), and revises the information in AU section 325A. SAS No. 115 was issued to eliminate differences within the AICPA’s Audit and Attest Standards resulting from the issuance of Statement on Standards for Attestation Engagements No. 15, An Examination of an Entity’s Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements (AICPA, Professional Standards, vol. 1, AT sec. 301). SAS No. 115 is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier application is permitted. Due to the issuance of SAS No. 115, extant AU section 325 has been moved to AU section 325A of the Professional Standards until the effective date of SAS No. 115. This manual references the “A” sections as appropriate because the changes due to SAS No. 115 has not been incorporated into this edition. See AAM section 8300, “Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115,” for further guidance.
Notes:

If one or more significant deficiencies have been identified, the auditor may add the following sentence to the fourth paragraph of the communication:

However, we identified certain deficiencies in internal control that we consider to be significant deficiencies, and communicated them in writing to management and those charged with governance on [date].

.12 Report on Controls Placed in Operation at a Service Organization

To XYZ Service Organization:

We have examined the accompanying description of controls related to the application of XYZ Service Organization. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of XYZ Service Organization’s controls that may be relevant to a user organization’s internal control as it relates to an audit of financial statements, (2) the controls included in the description were suitably designed to achieve the control objectives specified in the description, if those controls were complied with satisfactorily, and (3) such controls had been placed in operation as of ___. The control objectives were specified by ___. Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

We did not perform procedures to determine the operating effectiveness of controls for any period. Accordingly, we express no opinion on the operating effectiveness of any aspects of XYZ Service Organization’s controls, individually or in the aggregate.

In our opinion, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization’s controls that had been placed in operation as of ___. Also, in our opinion, the controls, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily.

The description of controls at XYZ Service Organization is as of ___ and any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the controls in existence. The potential effectiveness of specific controls at the Service Organization is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.

This report is intended solely for use by the management of XYZ Service Organization, its customers, and the independent auditors of its customers ___.

[Source: Paragraph .38 of AU section 324, Service Organizations (AICPA, Professional Standards, vol. 1)]

Notes:

This report should have an attachment containing a description of the service organization’s controls that may be relevant to a user organization’s internal control.

This report is illustrative only and should be modified as appropriate to suit the circumstances of individual engagements.

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13 See footnote 12.

14 If the application of controls by user organizations is necessary to achieve the stated control objectives, the service auditor’s report should be modified to include the phrase “and user organizations applied the controls contemplated in the design of XYZ Service Organization’s controls” following the words “complied with satisfactorily” in the scope and opinion paragraphs.
Paragraph .39 of AU section 324 provides, an example explanatory paragraph and modification to the opinion paragraph when the service auditor concludes that the description is inaccurate or insufficiently complete for user auditors.

Paragraph .40 of AU section 324 provides, an example explanatory paragraph and modification to the opinion paragraph when the service auditor concludes that there are significant deficiencies in the design or operation of the service organization’s controls.

.13 Report on Controls Placed in Operation at a Service Organization and Tests of Operating Effectiveness

To XYZ Service Organization:

We have examined the accompanying description of controls related to the ___ application of XYZ Service Organization. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of XYZ Service Organization’s controls that may be relevant to a user organization’s internal control as it relates to an audit of financial statements, (2) the controls included in the description were suitably designed to achieve the control objectives specified in the description, if those controls were complied with satisfactorily, and (3) such controls had been placed in operation as of ___. The control objectives were specified by ___. Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

In our opinion, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization’s controls that had been placed in operation as of ___. Also, in our opinion, the controls, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily.

In addition to the procedures we considered necessary to render our opinion as expressed in the previous paragraph, we applied tests to specific controls, listed in Schedule X, to obtain evidence about their effectiveness in meeting the control objectives, described in Schedule X, during the period from __ to __. The specific controls and the nature, timing, extent, and results of the tests are listed in Schedule X. This information has been provided to user organizations of XYZ Service Organization and to their auditors to be taken into consideration, along with information about the internal control at user organizations, when making assessments of control risk for user organizations. In our opinion the controls that were tested, as described in Schedule X, were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objectives specified in Schedule X were achieved during the period from __ to __. [However, the scope of our engagement did not include tests to determine whether control objectives not listed in Schedule X were achieved; accordingly, we express no opinion on the achievement of control objectives not included in Schedule X.]

The relative effectiveness and significance of specific controls at XYZ Service Organization and their effect on assessments of control risk at user organizations are dependent on their interaction with the controls and other factors present at individual user organizations. We have performed no procedures to evaluate the effectiveness of controls at individual user organizations.

The description of controls at XYZ Service Organization is as of ___, and information about tests of the operating effectiveness of specific controls covers the period from __ to ___. Any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the controls in existence. The potential effectiveness of specific controls at the Service Organization is subject to inherent

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15 If the application of controls by user organizations is necessary to achieve the stated control objectives, the service auditor’s report should be modified to include the phrase “and user organizations applied the controls contemplated in the design of XYZ Service Organization’s controls” following the words “complied with satisfactorily” in the scope and opinion paragraphs.

16 This sentence should be added when all of the control objectives listed in the description of controls placed in operation are not covered by the tests of operating effectiveness. This sentence would be omitted when all of the control objectives listed in the description of controls placed in operation are included in the tests of operating effectiveness.
limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.

This report is intended solely for use by the management of XYZ Service Organization, its customers, and the independent auditors of its customers.

[Source: Paragraph .54 of AU section 324]

Notes:

This report should have two attachments: (a) a description of the service organization’s controls that may be relevant to a user organization’s internal control as it relates to an audit of financial statements and (b) a description of controls for which tests of operating effectiveness were performed, the control objectives the controls were intended to achieve, the tests applied, and the results of these tests.

This report is illustrative only and should be modified as appropriate to suit the circumstances of individual engagements.

Paragraph .55 of AU section 324 provides an example explanatory paragraph and modification to the opinion paragraph when the service auditor concludes that the description is inaccurate or insufficiently complete for user auditors.

Paragraph .56 of AU section 324 provides an example explanatory paragraph and modification to the opinion paragraph when the service auditor concludes that there are sufficient deficiencies in the design or operation of the service organization’s controls.

.14 Reports on Internal Control Required by SEC Rule 17a-5

The following is an illustration of the independent auditor’s report on internal control required by Securities and Exchange Commission (SEC) Rule 17a-5(g)(1).

Board of Directors

Standard Stockbrokerage Co., Inc.

In planning and performing our audit of the [consolidated] financial statements of Standard Stockbrokerage Co., Inc. [and Subsidiaries] (the Company), as of and for the year ended December 31, 20X8, in accordance with auditing standards generally accepted in the United States of America, we considered the Company’s internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the [consolidated] financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control. Accordingly, we do not express an opinion on the effectiveness of the Company’s internal control.

17 For audits conducted in accordance with Public Company Accounting Oversight Board (PCAOB) standards, PCAOB Auditing Standard No. 1, References in Auditors’ Reports to the Standards of the Public Company Accounting Oversight Board (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”), replaces this sentence with the following sentence: “We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States).” On May 14, 2004, the SEC issued an interpretive release to help with the implementation of PCAOB Auditing Standard No. 1. See Release No. 33-8422 for more information. The release specifies that effective May 14, 2004, references in SEC rules and staff guidance and in the federal securities laws to GAAS or to specific standards under GAAS, as they relate to issuers, should be understood to mean the standards of the PCAOB, plus any applicable rules of the SEC. The guidance in this release is applicable only to auditors’ engagements that are governed by PCAOB rules. The PCAOB, for example, has not established particular auditing standards for nonissuer broker-dealers or investment advisers. This release is not applicable to such engagements and related filings.

The staff of the PCAOB published a series of questions and answers on PCAOB Auditing Standard No. 1. See the PCAOB Web site at www.pcaobus.org for more information.

In June 2004, the Auditing Standards Board (ASB) issued Interpretation No. 18, “Reference to PCAOB Standards in an Audit Report of a Nonissuer,” of AU section 508, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1, AU sec. 9508 par. 89–92), which provides reporting guidance for audits of nonissuers. Interpretation No. 18 in AU section 9508 provides guidance on the appropriate referencing of PCAOB auditing standards in audit reports when an auditor is engaged to perform the audit in accordance with both GAAS and PCAOB auditing standards. The ASB also is revising AU section 508 (AICPA, Professional Standards, vol. 1) in light of the International Auditing and Assurance Standards Board’s recently exposed International Standard on Auditing, The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements, and PCAOB Auditing Standard No. 1. See the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards for more information.

AICPA Audit and Accounting Manual AAM §9250.14
Also, as required by Rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study
of the practices and procedures followed by the Company, including consideration of control activities for
safeguarding securities. This study included tests of compliance with such practices and procedures that we
considered relevant to the objectives stated in Rule 17a-5(g), in the following:

1. Making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital
under Rule 17a-3(a)(11) and the reserve required by Rule 15c3-3(e)
2. Making the quarterly securities examinations, counts, verifications, and comparisons, and the
recordation of differences required by Rule 17a-13
3. Complying with the requirements for prompt payment for securities under Section 8 of Federal
Reserve Regulation T of the Board of Governors of the Federal Reserve System
4. Obtaining and maintaining physical possession or control of all fully paid and excess margin
securities of customers as required by Rule 15c3-3

The management of the Company is responsible for establishing and maintaining internal control and the
practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and
judgments by management are required to assess the expected benefits and related costs of controls, and of
the practices and procedures referred to in the preceding paragraph, and to assess whether those practices and
procedures can be expected to achieve the SEC’s above-mentioned objectives. Two of the objectives of internal
control and the practices and procedures are to provide management with reasonable but not absolute
assurance that assets for which the Company has responsibility are safeguarded against loss from unautho-
rized use or disposition, and that transactions are executed in accordance with management’s authorization
and recorded properly to permit the preparation of financial statements in conformity with generally accepted
accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the
preceding paragraph.

Because of inherent limitations in internal control and the practices and procedures referred to above, error
or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject
to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their
design and operation may deteriorate.

A control deficiency exists when the design or operation of a control does not allow management or employees,
in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely
basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely
affects the entity’s ability to initiate, authorize, record, process, or report financial data reliably in accordance
with generally accepted accounting principles such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented or detected by the entity’s internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more
than a remote likelihood that a material misstatement of the financial statements will not be prevented or
detected by the entity’s internal control.

Our consideration of internal control was for the limited purpose described in the first and second paragraphs
and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We
did not identify any deficiencies in internal control and control activities for safeguarding securities that we consider to be material weaknesses, as defined above.\(^{19}\)

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the SEC to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company’s practices and procedures, as described in the second paragraph of this report, were adequate at December 31, 20X8, to meet the SEC’s objectives.\(^{20}\)

This report is intended solely for the information and use of the Board of Directors, management, the SEC, [Designated self-regulatory organization], and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 in their regulation of registered brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm
New York, New York
February 15, 20X9

[Source: AICPA Audit and Accounting Guide Brokers and Dealers in Securities, updated as of May 1, 2008, appendix C\(^{21}\) ]

Note:
AAM section 9650 illustrates the auditor’s reports on the financial statements of brokers and dealers in securities.

\section{.15 Report on Internal Control Required by SEC Rule 17a-5 (g) (1) for a Broker-Dealer Claiming an Exemption From SEC Rule 15c3-3}

The following is an illustration of an independent auditor’s report on internal control of a broker-dealer claiming an exemption from Securities and Exchange Commission (SEC) Rule 15c3-3.\(^ {22, 23} \)

\(^{19}\) If significant deficiencies are identified, this paragraph can be modified by inserting, “However, we identified certain deficiencies in internal control that we consider to be significant deficiencies, and communicated them in writing to management and those charged with governance on [date].” Paragraph 29 of AU section 325A states that the auditor should not issue a written communication stating that no significant deficiencies were identified because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.

If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor’s attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of this paragraph of the report should be modified as follows:

However, we identified the following deficiencies in [internal control or control activities for safeguarding securities] that we consider to be material weaknesses, as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures performed in our audit of the [consolidated] financial statements of Standard Stockbrokerage Co., Inc. [and Subsidiaries] as of and for the year ended December 31, 20X8, and this report does not affect our report thereon dated February 15, 20X9. [A description of the material weaknesses that have come to the auditor’s attention and corrective action.]

\(^{20}\) Whenever inadequacies are described, the last sentence of this paragraph should be modified as per footnote 19. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period, unless management already has reported them to the SEC.

\(^{21}\) See footnote 12.

\(^{22}\) For audits conducted in accordance with Public Company Accounting Oversight Board (PCAOB) standards, PCAOB Auditing Standard No. 1, References in Auditors’ Reports to the Standards of the Public Company Accounting Oversight Board (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”), replaces this sentence with the following sentence: “We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States).” On May 14, 2004, the Securities and Exchange Commission (SEC) issued an interpretive release to help with the implementation of PCAOB Auditing Standard No. 1. See Release No. 33-8422 for more information. The release specifies that effective May 14, 2004, references in SEC rules and staff guidance and in the federal securities laws to generally accepted auditing standards (GAAS) or to specific standards under GAAS, as they relate to issuers, should be understood to mean the standards of the PCAOB, plus any applicable rules of the SEC. The guidance in this release is applicable only to auditors’ engagements that are governed by PCAOB rules. The PCAOB, for example, has not established particular auditing standards for nonissuer broker-dealers or investment advisers. This release is not applicable to such engagements and related filings.

The staff of the PCAOB published a series of questions and answers (Q&As) on PCAOB Auditing Standard No. 1. See the PCAOB Web site at www.pcaobus.org for more information.

\(^{23}\) In June 2004, the Auditing Standards Board (ASB) issued Interpretation No. 18, “Reference to PCAOB Standards in an Audit Report of a Nonissuer,” of AU section 508, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1, AU sec. 9508 par. 89–92), which provides reporting guidance for audits of nonissuers. Interpretation No. 18 provides guidance on the appropriate referencing of
In planning and performing our audit of the [consolidated] financial statements of Standard Stockbrokerage Co., Inc. and Subsidiaries (the Company), as of and for the year ended December 31, 20X8 in accordance with auditing standards generally accepted in the United States of America, we considered the Company’s internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the [consolidated] financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control. Accordingly, we do not express an opinion on the effectiveness of the Company’s internal control.

Also, as required by Rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company including consideration of control activities for safeguarding securities. This study included tests of such practices and procedures that we considered relevant to the objectives stated in Rule 17a-5(g) in making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under Rule 17a-3(a)(11) and for determining compliance with the exemptive provisions of Rule 15c3-3. Because the Company does not carry securities accounts for customers or perform custodial functions relating to customer securities, we did not review the practices and procedures followed by the Company in any of the following:

1. Making quarterly securities examinations, counts, verifications, and comparisons and recordation of differences required by Rule 17a-13

2. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls and of the practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the SEC’s above-mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management’s authorization and recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control and the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity’s ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity’s financial statements that is more than inconsequential will not be prevented or detected by the entity’s internal control.  

PCAOB auditing standards in audit reports when an auditor is engaged to perform the audit in accordance with both GAAS and PCAOB auditing standards. The ASB also is revising AU section 508 in light of the International Auditing and Assurance Standards Board’s recently exposed International Standard on Auditing The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements and PCAOB Auditing Standard No. 1. See the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards for more information.

23 There are different types of exemptions under SEC Rule 15c3-3-k(1),k(2)(i), and k(2)(ii). Other formats of this letter will be required depending on the type of exemption filed.

24 See footnote 18.
A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity’s internal control.

Our consideration of internal control was for the limited purpose described in the first and second paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities that we consider to be material weaknesses, as defined above.\(^{25}\)

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the SEC to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company’s practices and procedures, as described in the second paragraph of this report, were adequate at December 31, 20X8, to meet the SEC’s objectives.\(^{26}\)

This report is intended solely for the information and use of the Board of Directors, management, the SEC, [Designated self-regulatory organization], and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 in their regulation of registered brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm  
New York, New York  
February 15, 20X8

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, updated as of May 1, 2008, appendix D\(^{27}\)]

**Note:**

AAM section 9650 illustrates the auditor’s reports on the financial statements of brokers and dealers in securities.

.16 **Letter to SEC When the Broker-Dealer Has Not Made the Required Notification**

The following report is appropriate if the broker-dealer has not made the required notification of material inadequacy or if the auditor does not agree with the statements therein. Modification of this letter may be required based on the facts and circumstances of the particular situation.

Securities and Exchange Commission  
Washington D.C., and [Appropriate regional office]  
Designated Examining Authority

Dear Sirs:

\(^{25}\) If significant deficiencies are identified, this paragraph can be modified by inserting “However, we identified certain deficiencies in internal control that we consider to be significant deficiencies, and communicated them in writing to management and those charged with governance on [date].” AU section 325A paragraph .29 states that the auditor should not issue a written communication stating that no significant deficiencies were identified because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.

If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor’s attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of this paragraph of the report should be modified as follows:

However, we identified the following deficiencies in [internal control or control activities for safeguarding securities] that we consider to be material weaknesses, as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures performed in our audit of the [consolidated] financial statements of Standard Stockbrokerage Co., Inc. [and Subsidiaries] as of and for the year ended December 31, 2007, and this report does not affect our report thereon dated February 15, 20X8. [A description of the material weaknesses that have come to the auditor’s attention and corrective action.]

\(^{26}\) Whenever inadequacies are described, the last sentence of this paragraph should be modified as per footnote 25. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period, unless management already has reported them to the SEC.

\(^{27}\) See footnote 21.

AICPA Audit and Accounting Manual
Our most recent audit of the [consolidated] financial statements of Standard Stockbrokerage Co., Inc. [and Subsidiaries] (the Company), was as of December 31, 20X7, and for the year then ended, which we reported on under date of February 15, 20X8. We have not audited any financial statements of the Company as of any date or for any period subsequent to December 31, 20X7. Although we are presently performing certain procedures as part of our audit of the [consolidated] financial statements of the Company as of December 31, 20X8, and for the year then ending, these procedures do not constitute all the procedures necessary in an audit conducted in accordance with auditing standards generally accepted in the United States of America or all the procedures necessary to (1) consider the Company’s internal control as required by generally accepted auditing standards or (2) study the Company’s practices and procedures relevant to the objectives stated in Rule 17a-5(g) of the Securities and Exchange Commission as required by Rule 17a-5.

The management of the Company is responsible for establishing and maintaining internal control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls. The objectives of internal control are to provide management with reasonable but not absolute assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management’s authorization and are recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles. Because of inherent limitations in internal control, error or fraud may occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the effectiveness of the design and operation of controls may deteriorate.

The purpose of performing certain procedures prior to the date of the financial statements is to facilitate the expression of an opinion on the Company’s financial statements. It must be understood that the procedures performed would not necessarily identify all material weaknesses in internal control and control activities for safeguarding securities.

However, pursuant to the requirements of Rule 17a-5(h)(2), we are to call to the attention of the chief financial officer any weaknesses that we believe to be material and that were disclosed during the course of interim work. We have made such notification to the chief financial officer of Standard Stockbrokerage Co., Inc., and we believe the following additional information is required pursuant to the requirements of the rule.

[List and describe all instances where the independent auditor did not agree with the notification of the broker or dealer or where the required notification was not made.]

Accounting Firm
New York, New York
December 10, 20X7

[Source: AICPA Audit and Accounting Guide Brokers and Dealers in Securities, updated as of May 1, 2008, appendix E]

Note:

AAM section 9650 illustrates the auditor’s reports on the financial statements of brokers and dealers in securities.

.17 Report on Internal Control Required by CFTC Regulation 1.16 and SEC Rule 17a-5(g)(1)

The following is an illustration of the independent auditor’s report on internal control required by CFTC Regulation 1.16 and SEC Rule 17a-5(g)(1).28

Board of Directors
Standard Stockbrokerage Co., Inc.:
In planning and performing our audit of the [consolidated] financial statements of Standard Stockbrokerage Co., Inc. [and Subsidiaries] (the Company) as of and for the year ended December 31, 20X8, in accordance with auditing standards generally accepted in the United States of America, we considered the Company’s internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the [consolidated] financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control. Accordingly, we do not express an opinion on the effectiveness of the Company’s internal control.

Also, as required by Rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company, including consideration of control activities for safeguarding securities. This study included tests of compliance with such practices and procedures that we considered relevant to the objectives stated in Rule 17a-5(g), in the following:

1. Making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under Rule 17a-3(a)(11) and the reserve required by Rule 15c3-3(e)
2. Making the quarterly securities examinations, counts, verifications, and comparisons, and the recordation of differences required by Rule 17a-13
3. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System
4. Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3.

In addition, as required by Regulation 1.16 of the Commodity Futures Trading Commission (CFTC), we have made a study of the practices and procedures followed by the Company including consideration of control activities for safeguarding customer and firm assets. This study included tests of such practices and procedures that we considered relevant to the objectives stated in Regulation 1.16, in making the following:

1. The periodic computations of minimum financial requirements pursuant to Regulation 1.17
2. The daily computations of the segregation requirements of Section 4d(a)(2) of the Commodity Exchange Act and the regulations thereunder, and the segregation of funds based on such computations
3. The daily computations of the foreign futures and foreign options secured amount requirements pursuant to Regulation 30.7 of the CFTC.

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraphs. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls and of the practices and procedures referred to in the preceding paragraphs and to assess whether those practices and procedures can be expected to achieve the SEC’s and the CFTC’s above-mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management’s authorization and recorded properly to permit preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) and Regulation 1.16(d)(2) list additional objectives of the practices and procedures listed in the preceding paragraphs.

Because of inherent limitations in internal control and the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely
basis. A significant deficiency\(^{29}\) is a control deficiency, or combination of control deficiencies, that adversely affects the entity’s ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity’s financial statements that is more than inconsequential will not be prevented or detected by the entity’s internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity’s internal control.

Our consideration of internal control was for the limited purpose described in the first, second and third paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities and certain regulated commodity customer and firm assets that we consider to be material weaknesses, as defined above.\(^{30}\)

We understand that practices and procedures that accomplish the objectives referred to in the second and third paragraphs of this report are considered by the SEC and CFTC to be adequate for their purposes in accordance with the Securities Exchange Act of 1934, the Commodity Exchange Act, and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company’s practices and procedures, as described in the second and third paragraphs of this report, were adequate at December 31, 20X8, to meet the SEC’s and CFTC’s objectives.\(^{31}\)

This report is intended solely for the information and use of the Board of Directors, management, the SEC, the CFTC, [Designated Self-Regulatory Organization] and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 or Regulation 1.16 of the CFTC or both in their regulation of registered broker-dealers and futures commission merchants, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm
New York, New York
February 15, 20X8

[Source: AICPA Audit and Accounting Guide Brokers and Dealers in Securities, updated as of May 1, 2008, appendix F\(^{32}\) ]

[The next page is 9521.]

\(^{29}\) See footnote 18.

\(^{30}\) See footnote 25.

\(^{31}\) Whenever inadequacies are described, the last sentence of this paragraph should be modified as per footnote 30. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period, unless management already has reported them to the SEC and the CFTC.

\(^{32}\) See footnote 21.
AAM Section 9260

Special Reports

.01 Cash Basis Statements

Independent Auditor’s Report

Addressee:

We have audited the accompanying statements of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of revenue collected and expenses paid for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared on the basis of cash receipts and disbursements, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities arising from cash transactions of XYZ Company as of December 31, 20X2 and 20X1, and its revenue collected and expenses paid during the years then ended, on the basis of accounting described in Note X.

[Signature]

[Date]

[Source: Paragraph .08 of AU section 623, Special Reports (AICPA, Professional Standards, vol. 1)]
.02 Income Tax Basis Statements

Independent Auditor’s Report

Addressee:

We have audited the accompanying statements of assets, liabilities, and capital—income tax basis of ABC Partnership as of December 31, 20X2 and 20X1, and the related statements of revenue and expenses—income tax basis and of changes in partners’ capital accounts—income tax basis for the years then ended. These financial statements are the responsibility of the Partnership’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared on the basis of accounting the Partnership uses for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and capital of ABC Partnership as of December 31, 20X2 and 20X1, and its revenue and expenses and changes in partners’ capital accounts for the years then ended, on the basis of accounting described in Note X.

[Signature]

[Date]

[Source: Paragraph .08 of AU section 623]
Regulatory (Statutory) Basis Statements

Independent Auditor’s Report

Addressee:

We have audited the accompanying statements of admitted assets, liabilities, and surplus—statutory basis of XYZ Insurance Company as of December 31, 20X2 and 20X1, and the related statements of income and cash flows—statutory basis and changes in surplus—statutory basis for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared in conformity with the accounting practices prescribed or permitted by the Insurance Department of [State], which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the board of directors and management of XYZ Insurance Company and [name of regulatory agency] and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: Paragraph .08 of AU section 623]
.04 Report Relating to Amount of Sales for the Purpose of Computing Rental

(Report on one or more specified elements, accounts, or items of a financial statement)

Independent Auditor’s Report

Addressee:

We have audited the accompanying schedule of gross sales (as defined in the lease agreement dated March 4, 20XX, between ABC Company, as lessor, and XYZ Stores Corporation, as lessee) of XYZ Stores Corporation at its Main Street store, [City], [State], for the year ended December 31, 20X2. This schedule is the responsibility of XYZ Stores Corporation’s management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of gross sales is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule of gross sales. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of gross sales referred to above presents fairly, in all material respects, the gross sales of XYZ Stores Corporation at its Main Street store, [City], [State], for the year ended December 31, 20X2, as defined in the lease agreement referred to in the first paragraph.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Stores Corporation and ABC Company and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: Paragraph .18 of AU section 623]
.05 Royalties

(Report on one or more specified elements, accounts, or items of a financial statement)

Independent Auditor’s Report

Addressee:

We have audited the accompanying schedule of royalties applicable to engine production of the Q Division of XYZ Corporation for the year ended December 31, 20X2, under the terms of a license agreement dated May 14, 20XX, between ABC Company and XYZ Corporation. This schedule is the responsibility of XYZ Corporation’s management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of royalties is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule of royalties. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

We have been informed that, under XYZ Corporation’s interpretation of the agreement referred to in the first paragraph, royalties were based on the number of engines produced after giving effect to a reduction for production retirements that were scrapped, but without a reduction for field returns that were scrapped, even though the field returns were replaced with new engines without charge to customers.

In our opinion, the schedule of royalties referred to above presents fairly, in all material respects, the number of engines produced by the Q Division of XYZ Corporation during the year ended December 31, 20X2, and the amount of royalties applicable thereto, under the license agreement referred to above.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Corporation and ABC Company and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: Paragraph .18 of AU section 623]
.06 Profit Participation

(Report on one or more specified elements, accounts, or items of a financial statement)

Independent Auditor’s Report

Addressee:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company for the year ended December 31, 20X1, and have issued our report thereon dated March 10, 20X2. We have also audited XYZ Company’s schedule of John Smith’s profit participation for the year ended December 31, 20X1. This schedule is the responsibility of the Company’s management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit of the schedule in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of profit participation is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

We have been informed that the documents that govern the determination of John Smith’s profit participation are (a) the employment agreement between John Smith and XYZ Company dated February 1, 20X0, (b) the production and distribution agreement between XYZ Company and Television Network Incorporated dated March 1, 20X0, and (c) the studio facilities agreement between XYZ Company and QRX Studios dated April 1, 20X0, as amended November 1, 20X0.

In our opinion, the schedule of profit participation referred to above presents fairly, in all material respects, John Smith’s participation in the profits of XYZ Company for the year ended December 31, 20X1, in accordance with the provisions of the agreements referred to above.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Company and John Smith and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]
[Date]
[Source: Paragraph .18 of AU section 623]

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If a specified element, account, or item is, or is based upon, an entity’s net income or stockholders’ equity or the equivalent thereof, the auditor should have audited the complete financial statements to express an opinion on the specified element, account, or item.
.07 Report on Federal and State Income Taxes Included in Financial Statements

(Report on one or more specified elements, accounts, or items of a financial statement)

Independent Auditor’s Report

Addressee:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company, Inc., for the year ended June 30, 20XX, and have issued our report thereon dated August 15, 20XX. We have also audited the current and deferred provision for the Company’s federal and state income taxes for the year ended June 30, 20XX, included in those financial statements, and the related asset and liability tax accounts as of June 30, 20XX. This income tax information is the responsibility of the Company’s management. Our responsibility is to express an opinion on it based on our audit.

We conducted our audit of the income tax information in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the federal and state income tax accounts are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures related to the federal and state income tax accounts. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the federal and state income tax accounts. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the Company has paid or, in all material respects, made adequate provision in the financial statements referred to above for the payment of all federal and state income taxes and for related deferred income taxes that could be reasonably estimated at the time of our audit of the financial statements of XYZ Company, Inc., for the year ended June 30, 20XX.

[Signature]

[Date]

[Source: Paragraph .18 of AU section 623]
.08 Report in Connection With a Proposed Acquisition

Independent Accountant’s Report
on Applying Agreed-Upon Procedures

To the Board of Directors and Management of X Company:

We have performed the procedures enumerated below, which were agreed to by the Board of Directors and Management of X Company, solely to assist you in connection with the proposed acquisition of Y Company as of December 31, 20XX. Y Company is responsible for its cash and accounts receivable records. This agreed-upon procedures engagement was conducted 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 parties specified in this 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.

The procedures and the associated findings are as follows:

Cash

1. We obtained confirmation of the cash on deposit from the following banks, and we agreed the confirmed balance to the amount shown on the bank reconciliations maintained by Y Company. We mathematically checked the bank reconciliations and compared the resultant cash balances per book to the respective general ledger account balances.

<table>
<thead>
<tr>
<th>Bank</th>
<th>General Ledger Account Balances as of December 31, 20XX</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC National Bank</td>
<td>$5,000</td>
</tr>
<tr>
<td>DEF State Bank</td>
<td>3,776</td>
</tr>
<tr>
<td>XYZ Trust Company regular</td>
<td>86,912</td>
</tr>
<tr>
<td>XYZ Trust Company payroll</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td><strong>$110,688</strong></td>
</tr>
</tbody>
</table>

We found no exceptions as a result of the procedures.

Accounts Receivable

2. We added the individual customer account balances shown in an aged trial balance of accounts receivable (identified as exhibit A) and compared the resultant total with the balance in the general ledger account.

We found no difference.

3. We compared the individual customer account balances shown in the aged trial balance of accounts receivable (exhibit A) as of December 31, 19XX, to the balances shown in the accounts receivable subsidiary ledger.

We found no exceptions as a result of the comparisons.

4. We traced the aging (according to invoice dates) for 50 customer account balances shown in exhibit A to the details of outstanding invoices in the accounts receivable subsidiary ledger. The balances selected for tracing were determined by starting at the eighth item and selecting every fifteenth item thereafter.

We found no exceptions in the aging of the amounts of the 50 customer account balances selected. The sample size traced was 9.8 percent of the aggregate amount of the customer account balances.
5. We mailed confirmations directly to the customers representing the 150 largest customer account balances selected from the accounts receivable trial balance, and we received responses as indicated below. We also traced the items constituting the outstanding customer account balance to invoices and supporting shipping documents for customers from which there was no reply. As agreed, any individual differences in a customer account balance of less than $300 were to be considered minor, and no further procedures were performed.

Of the 150 customer balances confirmed, we received responses from 140 customers; 10 customers did not reply. No exceptions were identified in 120 of the confirmations received. The differences disclosed in the remaining 20 confirmation replies were either minor in amount (as defined above) or were reconciled to the customer account balance without proposed adjustment thereto. A summary of the confirmation results according to the respective aging categories is as follows.

<table>
<thead>
<tr>
<th>Aging Categories</th>
<th>Customer Account Balances</th>
<th>Confirmations Requested</th>
<th>Confirmations Received</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>$156,000</td>
<td>$ 76,000</td>
<td>$ 65,000</td>
</tr>
<tr>
<td>Past due:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less than one month</td>
<td>60,000</td>
<td>30,000</td>
<td>19,000</td>
</tr>
<tr>
<td>One to three months</td>
<td>36,000</td>
<td>18,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Over three months</td>
<td>48,000</td>
<td>48,000</td>
<td>8,000</td>
</tr>
<tr>
<td></td>
<td><strong>$300,000</strong></td>
<td><strong>$172,000</strong></td>
<td><strong>$102,000</strong></td>
</tr>
</tbody>
</table>

We were not engaged to and did not conduct an audit, the objective of which would be the expression of an opinion on cash and accounts receivable. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the board of directors and management of X Company and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: Paragraph .48 of AT section 201, Agreed-Upon Procedures Engagements (AICPA, Professional Standards, vol. 1)]
To the Trustee of XYZ Company:

We have performed the procedures described below, which were agreed to by the Trustee of XYZ Company, with respect to the claims of creditors solely to assist you in determining the validity of claims of XYZ Company as of May 31, 20XX, as set forth in the accompanying Schedule A. XYZ Company is responsible for maintaining records of claims submitted by creditors of XYZ Company. This agreed-upon procedures engagement was conducted 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 party specified in this 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.

The procedures and associated findings are as follows:

1. Compare the total of the trial balance of accounts payable at May 31, 20XX, prepared by XYZ Company, to the balance in the related general ledger account.

   The total of the accounts payable trial balance agreed with the balance in the related general ledger account.

2. Compare the amounts for claims received from creditors (as shown in claim documents provided by XYZ Company) to the respective amounts shown in the trial balance of accounts payable. Using the data included in the claims documents and in XYZ Company’s accounts payable detail records, reconcile any differences found to the accounts payable trial balance.

   All differences noted are presented in column 3 of Schedule A. Except for those amounts shown in column 4 of Schedule A, all such differences were reconciled.

3. Obtain the documentation submitted by creditors in support of the amounts claimed and compare it to the following documentation in XYZ Company’s files: invoices, receiving reports, and other evidence of receipt of goods or services.

   No exceptions were found as a result of these comparisons.

We were not engaged to and did not conduct an audit, the objective of which would be the expression of an opinion on the claims of creditors set forth in the accompanying Schedule A. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the Trustee of XYZ Company and is not intended to be and should not be used by anyone other than this specified party.

[Signature]

[Date]

[Source: Paragraph .48 of AT section 201]
.10 Reporting on the Subject Matter

Independent Accountant’s Report

We have examined the accompanying XBRL Instance Document of XYZ Company, which reflects the data presented in the financial statements of XYZ Company as of December 31, 20XX, and for the year then ended [optional to include the location of the financial statements, such as “included in the Company’s Form 10-K for the year ended December 31, 20XX”]. XYZ Company’s management is responsible for the XBRL Instance Document. Our responsibility is to express an opinion based on our examination.

We have also audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company as of December 31, 20XX, and for the year then ended, and in our report dated [Month] XX, 20XX, we expressed an unqualified opinion on those financial statements.4, 5

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 XBRL Instance Document and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, the XBRL Instance Document of XYZ Company referred to above accurately reflects, in all material respects, the data presented in the financial statements in conformity with [identify the criteria—for example, specific XBRL taxonomy, such as the “XBRL U.S. Consumer and Industrial Taxonomy,” and where applicable, the company extension taxonomy, such as “XYZ Company’s extension taxonomy,” and the XBRL International Technical Specifications 2.0].

[Signature]

[Date]


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3 Financial information includes data presented in audited or reviewed financial statements or other financial information (for example, Management Discussion and Analysis).

4 If the financial statements have been reviewed, the sentence would read: “We have also reviewed, in accordance with [standards established by the American Institute of Certified Public Accountants] [Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants], the financial statements of XYZ Company as of March 31, 20XX, and for the three months then ended, the objective of which was the expression of limited assurance on such financial statements, and issued our report thereon dated [Month] XX, 20XX, [describe any modifications of such report].”

5 If the financial information has not been audited or reviewed, no reference to a report is required. The sentence would read: “We were not engaged to and did not conduct an audit or review of the [identify information], the objectives of which would have been the expression of an opinion or limited assurance on such [identify information]. Accordingly, we do not express an opinion or any other assurance on [it] [them].”

5 If the audit opinion on the related financial statements is other than unqualified, the practitioner should disclose that fact, and any substantive reasons therefore.
.11 Reporting on Management’s Assertions

Independent Accountant’s Report on Attest Engagements on Financial Information
Included in XBRL Instance Documents

We have examined management’s assertion that [identify the assertion—for example, the accompanying XBRL Instance Document accurately reflects the data presented in the financial statements of XYZ Company as of December 31, 20XX, and for the year then ended in conformity with (identify the criteria—for example, specific XBRL taxonomy, such as the “XBRL U.S. Consumer and Industrial Taxonomy,” and where applicable, the company extension taxonomy, such as “XYZ Company’s extension taxonomy,” and the XBRL International Technical Specifications 2.0)]. XYZ Company’s management is responsible for the assertion. Our responsibility is to express an opinion on the assertion based on our examination.

We have also audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company as of December 31, 20XX, and for the year then ended, and in our report dated [Month] XX, 20XX, we expressed an unqualified opinion on those financial statements.

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 XBRL Instance Document and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, management’s assertion referred to above is fairly stated, in all material respects, in conformity with [identify the criteria—for example, specific XBRL taxonomy, such as the “XBRL U.S. Consumer and Industrial Taxonomy,” and where applicable, the company extension taxonomy, such as “XYZ Company’s extension taxonomy,” and the XBRL International Technical Specifications 2.0]].

[Signature]

[Date]

[Source: Paragraphs .47–.55 of AT section 9101]

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6 Financial information includes data presented in audited or reviewed financial statements or other financial information (for example, Management Discussion and Analysis).
.12 Report on Compliance With Contractual Provisions (Given in a Separate Report)

Independent Auditor’s Report

We have audited, in accordance with auditing standards generally accepted in the United States of America, the balance sheet of XYZ Company as of December 31, 20X2, and the related statement of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated February 16, 20X3.

In connection with our audit, nothing came to our attention that caused us to believe that the Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to XX, inclusive, of the Indenture dated July 21, 20X0, with ABC Bank insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the boards of directors and management of XYZ Company and ABC Bank and is not intended to be and should not be used by anyone other than these specified parties.

[Source: Paragraph .21 of AU section 623]

Note:

When this report is included in the auditor’s standard report accompanying financial statements, the last two paragraphs are examples of the paragraphs that should follow the opinion paragraph of the auditor’s report on the financial statements.
.13 Report on Financial Statements Prepared Pursuant to Loan Agreements That Results in a Presentation Not in Conformity With Generally Accepted Accounting Principles or an Other Comprehensive Basis of Accounting

Independent Auditor’s Report

Addressee:

We have audited the special-purpose statement of assets and liabilities of ABC Company as of December 31, 20X2 and 20X1, and the related special-purpose statements of revenues and expenses and of cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The accompanying special-purpose financial statements were prepared for the purpose of complying with Section 4 of a loan agreement between DEF Bank and the Company as discussed in Note X, and are not intended to be a presentation in conformity with generally accepted accounting principles.

In our opinion, the special-purpose financial statements referred to above present fairly, in all material respects, the assets and liabilities of ABC Company at December 31, 20X2 and 20X1, and the revenues, expenses and cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the boards of directors and management of ABC Company and DEF Bank and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: Paragraph .30 of AU section 623]
.14 Report on a Schedule of Gross Income and Certain Expenses to Meet Regulatory Requirements and
to be Included in a Document Distributed to the General Public

Independent Auditor’s Report

Addressee:

We have audited the accompanying Historical Summaries of Gross Income and Direct Operating Expenses of ABC Apartments, City, State (Historical Summaries), for each of the three years in the period ended December 31, 20XX. These Historical Summaries are the responsibility of the Apartments’ management. Our responsibility is to express an opinion on the Historical Summaries based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Historical Summaries are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the Historical Summaries. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the Historical Summaries. We believe that our audits provide a reasonable basis for our opinion.

The accompanying Historical Summaries were prepared for the purpose of complying with the rules and regulations of the Securities and Exchange Commission (for inclusion in the registration statement on Form S-11 of DEF Corporation) as described in Note X and are not intended to be a complete presentation of the Apartments’ revenues and expenses.

In our opinion, the Historical Summaries referred to above present fairly, in all material respects, the gross income and direct operating expenses described in Note X of ABC Apartments for each of the three years in the period ended December 31, 20XX, in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: Paragraph .26 of AU section 623]
.15 Report on a Statement of Assets Sold and Liabilities Transferred to Comply With a Contractual Agreement

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of net assets sold of ABC Company as of June 8, 20XX. This statement of net assets sold is the responsibility of ABC Company’s management. Our responsibility is to express an opinion on the statement of net assets sold based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the statement of net assets sold is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the statement. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the statement of net assets sold. We believe that our audit provides a reasonable basis for our opinion.

The accompanying statement was prepared to present the net assets of ABC Company sold to XYZ Corporation pursuant to the purchase agreement described in Note X, and is not intended to be a complete presentation of ABC Company’s assets and liabilities.

In our opinion, the accompanying statement of net assets sold presents fairly, in all material respects, the net assets of ABC Company as of June 8, 20XX sold pursuant to the purchase agreement referred to in Note X, in conformity with accounting principles generally accepted in the United States of America.

This report is intended solely for the information and use of the boards of directors and managements of ABC Company and XYZ Corporation and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: Paragraph .26 of AU section 623]
.16 Report on the Application of Accounting Principles

Introduction

We have been engaged to report on the appropriate application of accounting principles generally accepted in [country of origin of such principles] to the specific transaction described below. This report is being issued to ABC Company for assistance in evaluating accounting principles for the described specific transaction. Our engagement has been conducted in accordance with standards established by the American Institute of Certified Public Accountants.

Description of Transaction

The facts, circumstances, and assumptions relevant to the specific transaction as provided to us by the management of ABC Company are as follows:

Appropriate Accounting Principles

[Text discussing generally accepted accounting principles]

Concluding Comments

The ultimate responsibility for the decision on the appropriate application of accounting principles generally accepted in [country of origin of such principles] for an actual transaction rests with the preparers of financial statements, who should consult with their continuing accountant. Our judgment on the appropriate application of accounting principles generally accepted in [country of origin of such principles] for the described specific transaction is based solely on the facts provided to us as described above; should these facts and circumstances differ, our conclusion may change.

Restricted Use

This report is intended solely for the information and use of the board of directors and management of ABC Company and is not intended to be and should not be used by anyone other than these specified parties.

[Source: Paragraph .11 of AU section 625, Reports on the Application of Accounting Principles (AICPA, Professional Standards, vol. 1)]

Notes:

This illustrative report is intended for a reporting accountant either in connection with a proposal to obtain a new client or otherwise, should apply when preparing a written report on (1) The application of accounting principles to specified transactions, either completed or proposed, involving facts and circumstances of a specific entity (“specific transactions”), or (2) The type of opinion that may be rendered on a specific entity’s financial statements.

[Source: Paragraph .03 of AU section 625]

Because of the nature of a transaction not involving facts or circumstances of a specific entity (“hypothetical transaction”), a reporting accountant cannot know, for example, whether the continuing accountant has reached a different conclusion on the application of accounting principles for the same or similar transaction, or how the specific entity has accounted for similar transactions in the past. Therefore an accountant should not undertake an engagement to provide a written report on the application of accounting principles to a hypothetical transaction.

[Source: Paragraph .04 of AU section 625]
Independent Auditor’s Report

To the Board of Directors
ABC Property and Liability Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the related statutory statements of income and changes in surplus, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America.7 Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note X to the financial statements, the Company prepared these financial statements using accounting practices prescribed or permitted by the Insurance Department of the State of [State of domicile], which practices differ from accounting principles generally accepted in the United States of America. The effects on the financial statements of the variances between these statutory accounting practices and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of ABC Property and Liability Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows8 for the years then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and

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7 For audits conducted in accordance with PCAOB standards, PCAOB Auditing Standard No. 1, References in Auditors’ Reports to the Standards of the Public Company Accounting Oversight Board (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”), replaces this sentence with the following sentence: “We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States).”

Interpretation No. 18, “Reference to PCAOB Standards in an Audit Report on a Nonissuer,” of AU section 508, Reports on Financial Statements (AICPA, Professional Standards, vol. 1, AU sec. 9508 par. .89–.92), provides reporting guidance for audits of nonissuers. Interpretation No. 18 provides guidance on the appropriate referencing of PCAOB auditing standards in audit reports when an auditor is engaged to perform the audit in accordance with both generally accepted auditing standards and PCAOB auditing standards. The Auditing Standards Board also has undertaken a project to determine what amendments, if any, should be made to AU section 508. See the AICPA Web site at www.aicpa.org/members/div/auditstd/index.htm for more information.

This optional wording may be added in accordance with Interpretation No. 17, “Clarification in the Audit Report of the Extent of Testing Internal Control Over Financial Reporting With Generally Accepted Auditing Standards,” of AU section 508 (AICPA, Professional Standards, vol. 1, AU sec. 9508 par. .85–.88), which provides reporting guidance for audits of nonissuers. Interpretation No. 17 addresses how auditors may expand their independent audit report to explain that their consideration of internal control was sufficient to provide the auditor sufficient understanding to plan the audit and determine the nature, timing and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. If this optional language is added, then the remainder of the paragraph would read as follows:

An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

8 Reference to cash flows would not be needed if the entity, under generally accepted accounting principles, is not required to present a statement of cash flows.
the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Property and Liability Insurance Companies*, updated as of May 1, 2008, paragraph 8.30]

[The next page is 9571.]
AAM Section 9270

Unaudited Financial Statements of a Public Entity

.01 Disclaimer

(When an accountant is associated with the financial statements but has not audited or reviewed such statements)

Addressee:

The accompanying balance sheet of X Company as of December 31, 19X1, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[Signature]

[Date]

[Source: Paragraph .05 of AU section 504, Association With Financial Statements (AICPA, Professional Standards, vol. 1)]

Notes: The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

If the unaudited financial statements are those of a nonissuer, this example is not appropriate. See AAM sections 2610 and 2620.
.02 Current Period Financial Statements Unaudited—Prior Period Financial Statements Audited

Addressee:

The accompanying balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

The financial statements for the year ended December 31, 20X1, were audited by us (other accountants) and we (they) expressed an unqualified opinion on them in our (their) report dated March 1, 20X2, but we (they) have not performed any auditing procedures since that date.

[Signature]

[Date]

[Source: Paragraphs .05 and .16 of AU section 504]

Notes: The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

If the unaudited financial statements are those of a nonissuer, this example is not appropriate. See AAM sections 2610 and 2620.
.03 Disclaimer—Cash Basis Statements

(When an accountant is associated with unaudited financial statements of a public entity prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles)

Addressee:

The accompanying statement of assets and liabilities resulting from cash transactions of XYZ Corporation as of December 31, 19X1, and the related statement of revenues collected and expenses paid during the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[Signature]

[Date]

[Source: Paragraph .07 of AU section 504]

Notes: A note to the financial statements should describe how the basis of presentation differs from generally accepted accounting principles, but the monetary effect of such differences need not be stated.

The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

If the unaudited financial statements are those of a nonissuer, this example is not appropriate. See AAM sections 2610 and 2620.
04 Disclaimer—Regulatory (Statutory) Basis Statements

(When an accountant is associated with unaudited financial statements of a public entity prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles)

Addressee:

The accompanying statement of admitted assets, liabilities, and surplus—statutory basis of XYZ Insurance Company as of December 31, 20XX, and the related statements of income—statutory basis, cash flows—statutory basis, and changes in surplus—statutory basis for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[Signature]
[Date]

[Source: Paragraph .07 of AU section 504]

Notes: A note to the financial statements should describe how the basis of presentation differs from generally accepted accounting principles, but the monetary effect of such differences need not be stated.

The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

If the unaudited financial statements are those of a nonissuer, this example is not appropriate. See AAM sections 2610 and 2620.

[The next page is 9621.]
AAM Section 9280

Lack of Independence

.01 Disclaimer

Addressee:

We are not independent with respect to XYZ Company, and the accompanying balance sheet as of December 31, 19X1, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[Signature]
[Date]

[Source: Paragraph .10 of AU section 504, Association With Financial Statements (AICPA, Professional Standards, vol. 1)]

Notes: When an accountant is not independent, any procedures he or she might perform would not be in accordance with generally accepted auditing standards and he or she would be precluded from expressing an opinion on the financial statements. Accordingly, he or she should disclaim an opinion with respect to the financial statements and state specifically that he or she is not independent. The accountant should not include in his or her disclaimer the reasons for the lack of independence or any description of the procedures he or she has performed; including such matters might confuse readers concerning the importance of the lack of independence.

If the financial statements are those of a nonissuer, the accountant must consider the guidance in Statements on Standards for Accounting and Review Services. (See paragraph .03 of AAM section 2610.)

[The next page is 9671.]
AAM Section 9300

Review of Interim Financial Information

.01 Independent Accountant’s Report

Independent Accountant’s Report

Addressee:

We have reviewed the accompanying [describe the interim financial information or statements reviewed] of ABC Company and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended. This (These) interim financial information (statements) is (are) the responsibility of the company’s management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

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

[Signature]
[Date]


Note:  AU section 722A establishes standards and provides guidance on the nature, timing, and extent of the procedures to be performed by an independent accountant when conducting a review of interim financial information, as that term is defined in paragraph .02 of AU section 722A.


[The next page is 9701.]
AAM Section 9400

Accountants’ Reports on Condensed Financial Statements and Selected Financial Data

.01 Unqualified Opinion on Condensed Financial Statements

Independent Auditor’s Report

Addressee:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements.

In our opinion, the information set forth in the accompanying condensed consolidated financial statements is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

[Signature]

[Date]

[Source: Paragraph .06 of AU section 552, Reporting on Condensed Financial Statements and Selected Financial Data (AICPA, Professional Standards, vol. 1)]
.02 Adverse Opinion on Condensed Financial Statements Due to Inadequate Disclosure

Independent Auditor's Report

Addressee:

We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related earnings, and cash flows for the year then ended (not presented herein). These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The condensed consolidated balance sheet as of December 31, 20X0, and the related condensed statements of income, retained earnings, and cash flows for the year then ended, presented on pages xx-xx, are presented as a summary and therefore do not include all of the disclosures required by accounting principles generally accepted in the United States of America.

In our opinion, because of the significance of the omission of the information referred to in the preceding paragraph, the condensed consolidated financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of X Company and subsidiaries as of December 31, 20X0, or the results of its operations or its cash flows for the year then ended.

[Signature]
[Date]

Note: The above report is used when expressing an adverse opinion on condensed financial statements with inadequate disclosures that are included in a client-prepared document and the client is a nonissuer.

[Source: Footnote 6 in paragraph .07 of AU section 552]
Addressee:

We have reviewed the condensed consolidated balance sheet of ABC Company and subsidiaries as of March 31, 20X1, and the related condensed consolidated statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0. These financial statements are the responsibility of the company’s management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the condensed financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of ABC Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 20X0, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

[Signature]

[Date]


Note: This is an illustrative review report on a condensed balance sheet as of March 31, 20X1, and the related condensed statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0, and a condensed balance sheet derived from audited financial statements as of December 31, 20X0, that were included in Form 10-Q.

AAM Section 9500

Reports on Personal Financial Statements

.01 Auditor’s Standard Report

Independent Auditor’s Report

Addressee:

I (We) have audited the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended. These financial statements are the responsibility of James and Jane Person. My (Our) responsibility is to express an opinion on these financial statements based on my (our) audit.

I (We) conducted my (our) audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

In my (our) opinion, the financial statements referred to above present fairly, in all material respects, the financial condition of James and Jane Person as of [date], and the changes in their net worth for the [period] then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: AICPA Personal Financial Statements Guide, updated as of May 1, 2008, paragraph 5.14]
.02 Audit Report—Statement of Financial Condition Only

Independent Auditor’s Report

Addressee:

I (We) have audited the accompanying statement of financial condition of James and Jane Person as of [date]. This financial statement is the responsibility of James and Jane Person. My (Our) responsibility is to express an opinion on this financial statement based on my (our) audit.

I (We) conducted my (our) audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the statement of financial condition is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the statement of financial condition. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall presentation of the statement of financial condition. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

In my (our) opinion, the financial statement referred to above presents fairly, in all material respects, the financial condition of James and Jane Person as of [date] in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: AICPA Personal Financial Statements Guide, updated as of May 1, 2008, paragraph 5.21]
.03 Audit Report—Departure From GAAP—Inappropriate Valuation Methods—Adverse Opinion

Independent Auditor’s Report

Addressee:

I (We) have audited the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended. These financial statements are the responsibility of James and Jane Person. My (Our) responsibility is to express an opinion on these financial statements based on my (our) audit.

I (We) conducted my (our) audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

As discussed in Note X to the financial statements, assets amounting to $XX,XXX (XX percent of total assets) as of [date] have been valued at estimated current value as determined by James Person. I (We) have reviewed the procedures applied by James Person in valuing the assets and have inspected the underlying documentation. In my (our) opinion those procedures are not appropriate to determine the estimated current values of the assets in conformity with generally accepted accounting principles. The effects on the financial statements of not applying appropriate procedures to determine the estimated current values of the assets are not reasonably determinable.

In my (our) opinion, because of the effects of the matters discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial condition of James and Jane Person as of [date], or the changes in their net worth for the [period] then ended.

[Signature]
[Date]

[Source: AICPA Personal Financial Statements Guide, updated as of May 1, 2008, paragraph 5.19]
.04 Audit Report—Departure From GAAP—Inappropriate Valuation Methods—Qualified Opinion

Independent Auditor’s Report

Addressee:

I (We) have audited the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended. These financial statements are the responsibility of James and Jane Person. My (Our) responsibility is to express an opinion on these financial statements based on my (our) audit.

I (We) conducted my (our) audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

As discussed in Note X to the financial statements, assets amounting to $XX,XXX (XX percent of total assets) as of [date] have been valued at estimated current value as determined by James Person. I (We) have reviewed the procedures applied by James Person in valuing the assets and have inspected the underlying documentation. In my (our) opinion, these procedures are not appropriate to determine the estimated current values of the assets in conformity with generally accepted accounting principles. The effects on the financial statements of not applying appropriate procedures to determine the estimated current values of the assets are not reasonably determinable.

In my (our) opinion, except for the effects of the valuation of assets determined by James Person as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial condition of James and Jane Person as of [date], and the changes in their net worth for the [period] then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: AICPA Personal Financial Statements Guide, updated as of May 1, 2008, paragraph 5.18]
.05 Audit Report—Disclaim Opinion Because of Scope Limitation—Inadequate Records

Independent Auditor’s Report

Addressee:

I (We) were engaged to audit the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended. These financial statements are the responsibility of James and Jane Person.

James and Jane Person do not maintain accounting records sufficient to assure that all transactions are recorded. Accordingly, it was not practicable for me (us) to extend my (our) auditing procedures sufficiently to determine that all of their assets and liabilities and the changes in their net worth are recorded in the financial statements referred to above.

Since James and Jane Person do not maintain certain accounting records and supporting documentation and I was (we were) unable to apply adequate auditing procedures regarding the recording of transactions, the scope of my (our) work was not sufficient to enable me (us) to express, and I (we) do not express, an opinion on these financial statements.

[Signature]

[Date]

[Source: AICPA Personal Financial Statements Guide, updated as of May 1, 2008, paragraph 5.17]
.06 Audit Report—Scope Limitation—Inadequate Records

Independent Auditor’s Report

Addressee:

I (We) have audited the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended. These financial statements are the responsibility of James and Jane Person. My (Our) responsibility is to express an opinion on these financial statements based on my (our) audit.

Except as discussed in the following paragraph, I (we) conducted my (our) audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

James and Jane Person do not maintain accounting records sufficient to assure that all transactions are recorded. Accordingly, it was not practicable for me (us) to extend my (our) auditing procedures sufficiently to determine that all of their assets and liabilities and the changes in their net worth are recorded in the financial statements referred to above.

In my (our) opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had I (we) been able to determine that all assets and liabilities and changes in net worth were recorded in the financial statements, the financial statements referred to above present fairly, in all material respects, the financial condition of James and Jane Person as of [date], and the changes in their net worth for the [period] then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: AICPA Personal Financial Statements Guide, updated as of May 1, 2008, paragraph 5.16]
.07 Audit Report—Income Tax Basis

Independent Auditor's Report

Addressee:

I (We) have audited the accompanying statement of assets and liabilities—income tax basis of James and Jane Person as of [date], and the related statement of changes in net worth—income tax basis for the [period] then ended. These financial statements are the responsibility of James and Jane Person. My (Our) responsibility is to express an opinion on these financial statements based on my (our) audit.

I (We) conducted my (our) audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

As described in Note X, these financial statements were prepared on the basis of accounting James and Jane Person use for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In my (our) opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities of James and Jane Person as of [date], and the changes in their net worth for the [period] then ended on the basis of accounting described in Note X.

[Signature]

[Date]

[Source: AICPA Personal Financial Statements Guide, updated as of May 1, 2008, paragraph 5.20]
.08 Accountant’s Standard Compilation Report

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of the individuals whose financial statements are presented. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

[Signature]

[Date]

[Source: AICPA Personal Financial Statements Guide, updated as of May 1, 2008, paragraph 5.04]
.09 Compilation Report—Statement of Financial Condition Only

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [date], in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of the individuals whose financial statements are presented. I (We) have not audited or reviewed the accompanying statement of financial condition and, accordingly, do not express an opinion or any other form of assurance on it.

[Signature]

[Date]

[Source: AICPA Personal Financial Statements Guide, updated as of May 1, 2008, paragraph 5.21]
.10 Compilation Report—Omission of Substantially All Disclosures

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of the individuals whose financial statements are presented. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

James and Jane Person have elected to omit substantially all of the disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the financial condition of James and Jane Person and changes in their net worth. Accordingly, these financial statements are not designed for those who are not informed about such matters.

[Signature]

[Date]

[Source: AICPA Personal Financial Statements Guide, updated as of May 1, 2008, paragraph 5.05]

Note: When personal financial statements omit substantially all disclosures and do not disclose that the assets are presented at their estimated current values and that the liabilities are presented at their estimated current amounts, the accountant should include the following sentence at the end of the first paragraph of his or her report:

The financial statements are intended to present the assets of James and Jane Person at estimated current values and their liabilities at estimated current amounts.

[Source: AICPA Personal Financial Statements Guide, updated as of May 1, 2008, paragraph 5.06]
.11 Compilation Report—GAAP Departure—Material Assets at Cost

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of the individuals whose financial statements are presented. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them. However, I (we) did become aware of a departure from generally accepted accounting principles that is described in the following paragraph.

As disclosed in Note X to the financial statements, generally accepted accounting principles require that assets be presented at their estimated current values and that liabilities be presented at their estimated current amounts. James and Jane Person have informed me (us) that their investment in ABC Company is stated in the accompanying financial statements at cost and that the effects of this departure from generally accepted accounting principles on their financial condition and the changes in their net worth have not been determined.

[Signature]

[Date]

[Source: AICPA Personal Financial Statements Guide, updated as of May 1, 2008, paragraph 5.13]
.12 Compilation Report—Income Tax Basis

Addressee:

I (We) have compiled the accompanying statement of assets and liabilities—income tax basis of James and Jane Person as of [date], and the related statement of changes in net assets—income tax basis for the [period] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of the individuals whose financial statements are presented. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

[Signature]

[Date]

[Source: AICPA Personal Financial Statements Guide, updated as of May 1, 2008, paragraph 5.20]
.13 Compilation Report—Financial Statements Included in a Prescribed Form

Addressee:

I (We) have compiled the [identification of financial statements, including period covered and name of individual(s)] included in the accompanying prescribed form, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

My (Our) compilation was limited to presenting in the form prescribed by [name of body] information that is the representation of the individuals whose financial statements are presented. I (We) have not audited or reviewed the financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them.

These financial statements (including related disclosures) are presented in accordance with the requirements of [name of body], which differ from generally accepted accounting principles. Accordingly, these financial statements are not designed for those who are not informed about such differences.

[Signature]

[Date]

[Source: AICPA Personal Financial Statements Guide, updated as of May 1, 2008, paragraph 5.09]
.14 Accountant’s Standard Review Report

Addressee:

I (We) have reviewed the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of James and Jane Person.

A review consists principally of inquiries of the individuals whose financial statements are presented and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

[Signature]

[Date]

[Source: AICPA Personal Financial Statements Guide, updated as of May 1, 2008, paragraph 5.11]
Addressee:

I (We) have reviewed the accompanying statement of financial condition of James and Jane Person as of [date], in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in this financial statement is the representation of James and Jane Person.

A review of personal financial statements consists principally of inquiries of the individuals whose financial statements are presented and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying statement of financial condition in order for it to be in conformity with generally accepted accounting principles.

I (We) have reviewed the accompanying statement of financial condition of James and Jane Person as of [date], in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in this financial statement is the representation of James and Jane Person.

A review of personal financial statements consists principally of inquiries of the individuals whose financial statements are presented and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying statement of financial condition in order for it to be in conformity with generally accepted accounting principles.

[Signature]

[Date]

[Source: AICPA Personal Financial Statements Guide, updated as of May 1, 2008, paragraph 5.21]
.16 Review Report—GAAP Departure—Failure to Include a Provision for Estimated Income Taxes on the Differences Between the Estimated Current Values of Assets and the Estimated Current Amounts of Liabilities and Their Tax Bases

Addressee:

I (We) have reviewed the accompanying statement of financial condition of James Person as of [date], and the related statement of changes in net worth for the [period] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of James Person.

A review of personal financial statements consists principally of inquiries of the individual whose financial statements are presented and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, with the exception of the matter described in the following paragraph, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

Generally accepted accounting principles require that personal financial statements include a provision for estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases. The accompanying financial statements do not include such a provision and the effect of this departure from generally accepted accounting principles has not been determined.

[Signature]

[Date]

[Source: AICPA Personal Financial Statements Guide, updated as of May 1, 2008, paragraph 5.13]
.17 Review Report—Historical Cost Basis

Addressee:

I (We) have reviewed the accompanying statement of assets and liabilities—historical cost basis of James and Jane Person as of [date], and the related statement of changes in net assets—historical cost basis for the [period] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of James and Jane Person.

A review of personal financial statements consists principally of inquiries of the individuals whose financial statements are presented and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with the historical cost basis of accounting described in Note X.

[Signature]

[Date]

[Source: AICPA Personal Financial Statements Guide, updated as of May 1, 2008, paragraph 5.20]

[The next page is 9801.]
AAM Section 9600

Reports on Employee Benefit Plans

Practice Tip
Audits of 11-K Filers—Performance and Reporting Requirements

SEC Requirements
The Securities and Exchange Commission (SEC) requires employee stock purchase, savings and similar plans with interests that constitute securities registered under the Securities Act of 1933 to file Form 11-K pursuant to Section 15(d) of the Securities Exchange Act of 1934. Reports on Form 11-K must be filed within the SEC within 90 days after the end of the fiscal year of the plan, provided that plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) file the plan financial statements within 180 days after the plan’s fiscal year end.

Applicable Audit Standards
Plans that are required to file Form 11-Ks are deemed to be issuers under the Sarbanes-Oxley Act and must submit to the SEC an audit in accordance with the auditing and related professional practice standards promulgated by the Public Company Accounting Oversight Board (PCAOB).

Performance and Reporting Requirements
Based on AICPA staff discussions with the SEC and PCAOB staff to seek clarification of the performance and reporting requirements for audits of 11-K filers, firms will need to conduct their audits of these 11-K plans in accordance with two sets of standards and prepare two separate audit reports; an audit report referencing PCAOB standards for Form 11-K filings with the SEC and a separate audit report referencing generally accepted auditing standards (GAAS) for Department of Labor (DOL) filings. The PCAOB and SEC staff believe that an opinion issued in accordance with PCAOB Auditing Standard No. 1, References in Auditors’ Reports to the Standards of the Public Company Accounting Oversight Board (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”), does not allow a reference to GAAS, hence a “dual” standard report is not appropriate and will not be accepted by the SEC.

Any questions regarding performance and reporting requirements of audits of financial statements of Form 11-K filers should be directed to the SEC Division of Corporation Finance, Office of the Chief Accountant at (202) 942-2960.
.01 Unqualified Opinion—Defined Benefit Plan Assuming End-of-Year Benefit Information Date

Independent Auditor’s Report

Addressee:

We have audited the accompanying statements of net assets available for benefits and of accumulated plan benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan’s internal control over financial reporting. Accordingly, we express no such opinion.] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial status of the Plan as of December 31, 20X2 and 20X1, and the changes in its financial status for the year ended December 31, 20X2 in conformity with accounting principles generally accepted in the United States of America.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.04]

Note: Section 2520.103-1 of Title 29 U.S. Code of Federal Regulations (CFR) Part 2520.C requires the accountant’s report to be dated, manually signed, indicate the city and state where issued and identify the financial statements and schedules covered by the report.

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1 This optional language may be added to the auditor’s standard report to clarify that an audit performed in accordance with GAAS does not require the same level of testing and reporting on internal control over financial reporting as an audit of an issuer when Section 404(b) of the Sarbanes-Oxley Act is applicable. If this optional language is added then the remainder of the paragraph would read as follows:

An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

.02 Unqualified Opinion—Defined Benefit Plan Assuming Beginning-of-Year Benefit Information Date

Independent Auditor’s Report

Addressee:

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the related statements of changes in net assets available for benefits for the years then ended and the statement of accumulated plan benefits as of December 31, 20X1, and the related statement of changes in accumulated plan benefits for the year then ended. These financial statements are the responsibility of the Plan’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan’s internal control over financial reporting. Accordingly, we express no such opinion.]\(^2\) An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, information regarding the Plan’s net assets available for benefits as of December 31, 20X2, and changes therein for the year then ended and its financial status as of December 31, 20X1, and changes therein for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.05]

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\(^2\) This optional language may be added to the auditor’s standard report to clarify that an audit performed in accordance with GAAS does not require the same level of testing and reporting on internal control over financial reporting as an audit of an issuer when Section 404(b) of the Sarbanes-Oxley Act is applicable. If this optional language is added then the remainder of the paragraph would read as follows:

An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

See Interpretation No. 17 of AU section 508.
.03 Unqualified Opinion—Defined Contribution Profit-Sharing Plan

Independent Auditor’s Report

Addressee:

We have audited the accompanying statements of net assets available for benefits of ABC Company Profit-Sharing Plan as of December 31, 20X2 and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan’s internal control over financial reporting. Accordingly, we express no such opinion.] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 20X2 and 20X1, and the changes in net assets available for benefits for the year ended December 31, 20X2 in conformity with accounting principles generally accepted in the United States of America.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.06]

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3 This optional language may be added to the auditor’s standard report to clarify that an audit performed in accordance with GAAS does not require the same level of testing and reporting on internal control over financial reporting as an audit of an issuer when Section 404(b) of the Sarbanes-Oxley Act is applicable. If this optional language is added then the remainder of the paragraph would read as follows:

An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

See Interpretation No. 17 of AU section 508.
.04 Unqualified Opinion—Employee Health and Welfare Benefit Plans

Independent Auditor’s Report

Addressee:

We have audited the accompanying statements of net assets available for benefits and of plan benefit obligations of Allied Industries Benefit Plan as of December 31, 20X2 and 20X1, and the related statements of changes in net assets available for benefits and of changes in benefits obligations for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan’s internal control over financial reporting. Accordingly, we express no such opinion.] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial status of the Plan as of December 31, 20X2 and 20X1, and the changes in its financial status for the year ended December 31, 20X2 in conformity with accounting principles generally accepted in the United States of America.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.07]

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4 This optional language may be added to the auditor’s standard report to clarify that an audit performed in accordance with GAAS does not require the same level of testing and reporting on internal control over financial reporting as an audit of an issuer when Section 404(b) of the Sarbanes-Oxley Act is applicable. If this optional language is added then the remainder of the paragraph would read as follows:

An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

See Interpretation No. 17 of AU section 508.
.05 Unqualified Opinion—Supplemental Schedules Required by ERISA and DOL Regulations

Independent Auditor’s Report

Addressee:

Our audits were performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules of [identify title of schedules and period covered] are presented for the purpose of additional analysis and are not a required part of the basic financial statements but are supplementary information required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan’s management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.11]

Notes: This paragraph can be shown separately in the auditor-submitted document or as a separate paragraph, after the opinion paragraph, of the auditor’s standard report, when the auditor’s report covers additional information and the auditor has applied auditing procedures and is expressing an opinion on the additional information.

Examples of paragraphs that should be added to the standard auditor’s report when the report on the supplemental schedules is modified because of omitted information or an omitted schedule required by DOL regulations are presented in paragraphs .07-.08 and .18.
.06 Unqualified Opinion—Defined Benefit Pension Plan Prepared on the Modified Cash Basis

Independent Auditor’s Report

Addressee:

We have audited the accompanying statements of net assets available for benefits (modified cash basis) of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the related statement of changes in net assets available for benefits (modified cash basis) for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan’s internal control over financial reporting. Accordingly, we express no such opinion.] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements and supplemental schedules were prepared on a modified cash basis of accounting, which is a comprehensive basis of accounting other than GAAP.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the changes in net assets available for benefits for the year ended December 20X2, on the basis of accounting described in Note X.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules (modified cash basis) of [identify titles of schedules and period covered] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan’s management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.22]
Note: When reporting on financial statements prepared in conformity with a basis of accounting other than generally accepted accounting principles (GAAP), the auditor should consider whether the financial statements and notes thereto include all informative disclosures that are appropriate for the basis of accounting used. Interpretation No. 14, “Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA),” of AU section 623, Special Reports (AICPA, Professional Standards, vol. 1, AU sec. 9623 par. .90–.95), states that if cash, modified cash, or income tax basis financial statements contain elements, accounts, or items for which GAAP would require disclosure, the statements should either provide the relevant disclosure that would be required for those items in a GAAP presentation or provide information that communicates the substance of that disclosure. That may result in substituting qualitative information for some of the quantitative information required for GAAP presentations. Regardless of the basis of accounting used (GAAP or OCBOA), accumulated plan benefits disclosures should be made. If such disclosures are not made, the auditor should comment in his or her report on the lack of such disclosures and should express a qualified or adverse opinion on the financial statements. [Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.23]
.07 Modified Report—Omitted Information or Omitted Schedule Required Under DOL Regulations

Following are examples of paragraphs added to the auditor’s report when the auditor modifies his or her report on the supplemental schedules because of omitted information or an omitted schedule which is required under DOL regulations:

Independent Auditor’s Report

Addressee:

[Same first, second, and third paragraphs as the standard report. See paragraphs .01–.03 in this section.]

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [identify title of schedules and period covered] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan’s management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

The supplemental Schedule H, line 4i—Schedule of Assets (Held at End of Year) as of December 31, 20X2 that accompanies the Plan’s financial statements does not disclose the historical cost of certain nonparticipant directed plan assets held by the Plan trustee [or custodian]. Disclosure of this information is required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

or

The Plan has not presented the supplemental Schedule H, line 4j—Schedule of Reportable Transactions for the year ended December 31, 20X2. Disclosure of this information is required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.16]
.08 Qualified Opinion—Omitted or Incomplete Schedule or Material Inconsistency

The following are examples of paragraphs that have been added to the auditor’s report when the auditor qualifies his or her opinion on the supplemental schedules because a schedule, or information thereon, was omitted (when the schedules are not covered by a trustee’s certification as to completeness and accuracy), or because information in a required schedule is materially inconsistent with the financial statements.

Independent Auditor’s Report

Addressee:

[Same first, second, and third paragraphs as the standard report. See paragraphs .01-.03 in this section.]

The supplemental Schedule H, line 4i—Schedule of Assets (Held at End of Year) as of December 31, 20X2 that accompanies the Plan’s financial statements does not disclose that the Plan had loans to participants which are considered assets held for investment purposes. Disclosure of this information is required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [identify title of schedules and period covered] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan’s management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.16]
.09 Qualified Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted

The following are examples of paragraphs that have been added to the auditor’s report on the plan’s financial statements when the auditor qualifies his or her opinion on the supplemental schedules because disclosure of a material prohibited transaction with a party in interest is omitted.

Independent Auditor’s Report

Addressee:

[Same first, second, and third paragraphs as the standard report. See paragraphs .01–.03 in this section.]

The supplemental Schedule G, Part III—Schedule of Nonexempt Transactions that accompanies the plan’s financial statements does not disclose that the Plan [describe prohibited transaction]. Disclosure of this information is required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules [identify title of schedules and period covered] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan’s management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.17]
.10 Adverse Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted

The following are examples of paragraphs that have been added to the auditor’s report on the plan’s financial statements when the auditor decides that an adverse opinion should be expressed on the supplemental schedules because disclosure of a material prohibited transaction with a party in interest is omitted.

Independent Auditor’s Report

Addressee:

Same first, second, and third paragraphs as the standard report. See paragraphs .01–.03 in this section.

Schedule G, Part III—Schedule of Nonexempt Transactions that accompanies the plan’s financial statements does not disclose that the Plan [describe prohibited transaction]. Disclosure of this information is required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [identify title of schedules and period covered] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan’s management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, because of the omission of the information discussed in the preceding paragraph are not fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.17]
.11 Modified Report—Disclosure of Immaterial Prohibited Transaction With Party in Interest Omitted

The following are examples of paragraphs that have been added to the auditor’s report on the plan’s financial statements when the auditor decides to modify his or her report on the supplemental schedules because disclosure of a prohibited transaction with a party in interest that is not material to the financial statements has been omitted.

Independent Auditor’s Report

Addressee:

[Same first, second, and third paragraphs as the standard report. See paragraphs .01–.03 in this section.]

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [identify title of schedules and period covered] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan’s management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Schedule G, Part III—Schedule of Nonexempt Transactions that accompanies the plan’s financial statements does not disclose that the Plan [describe prohibited transaction]. Disclosure of this information, which is not considered material to the financial statements taken as a whole, is required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.17]

Independent Auditor’s Report

Addressee:

We have audited the accompanying statement of net assets available for benefits of XYZ Company Profit-Sharing Plan as of December 31, 20X1 and 20X0, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X1. These financial statements are the responsibility of the Plan’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Plan’s financial statements do not disclose that the Plan [describe related-party transaction]. Disclosure of this information is required by accounting principles generally accepted in the United States of America.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 20X1 and 20X0, and the changes in net assets available for benefits for the year ended December 31, 20X1 in conformity with accounting principles generally accepted in the United States of America.

Schedule G, Part III—Schedule of Nonexempt Transactions that accompanies the plan’s financial statements does not disclose that the plan [describe prohibited transaction]. Disclosure of this information is required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [identify title of schedules and period covered] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan’s management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.18]
Limited-Scope Audits Under DOL Regulations

Independent Auditor's Report

Addressee:

We were engaged to audit the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2 and the supplemental schedules of (1) Schedule H, line 4i-Schedule of Assets Held (At End of Year), and (2) Schedule H, line 4j-Schedule of Reportable Transactions as of or for the year ended December 31, 20X2. These financial statements and supplemental schedules are the responsibility of the Plan’s management.

As permitted by 29 CFR 2520.103-8 of the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee (or custodian) of the Plan, except for comparing such information with the related information included in the financial statements and supplemental schedules. We have been informed by the plan administrator that the trustee (or custodian) holds the Plan’s investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee (or custodian) as of December 31, 20X2 and 20X1 and for the year ended December 31, 20X2, that the information provided to the plan administrator by the trustee (or custodian) is complete and accurate.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and supplemental schedules taken as a whole. The form and content of the information included in the financial statements and supplemental schedules, other than that derived from the information certified by the trustee or custodian, have been audited by us in accordance with auditing standards generally accepted in the United States of America and, in our opinion, are presented in compliance with the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[Signature of Firm]

[City and State]
[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.26]

Note: If the plan’s financial statements are prepared on the cash basis or a modified cash basis of accounting, the auditor’s report should also include a paragraph stating the basis of presentation and that cash basis is a comprehensive basis of accounting other than GAAP (see paragraph 13.21 of the AICPA Audit and Accounting Guide Employee Benefit Plans, for wording of such a paragraph). [Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.26 footnote 6]
.14 Limited-Scope Audit in Prior Year

Independent Auditor’s Report

Addressee:

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2, and the statements of accumulated plan benefits as of December 31, 20X2 and 20X1, and the related statement of changes in accumulated plan benefits for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as explained in the following paragraph, we conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provide a reasonable basis for our opinion.

As permitted by 29 CFR 2520.103-8 of the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, investment assets held by ABC Bank, the trustee (or custodian) of the Plan, and transactions in those assets were excluded from the scope of our audit of the Plan’s 20X1 financial statements, except for comparing the information provided by the trustee (or custodian), which is summarized in Note X, with the related information included in the financial statements.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the Plan’s financial statements as of December 31, 20X1. The form and content of the information included in the 20X1 financial statements, other than that derived from the information certified by the trustee (or custodian), have been audited by us and, in our opinion, are presented in compliance with the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

In our opinion, the financial statements, referred to above, of XYZ Pension Plan as of December 31, 20X2, and for the year then ended present fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 20X2, and changes in its financial status for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit of the Plan’s financial statements as of and for the year ended December 31, 20X2, was made for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [identify title of schedules and period covered] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan’s management. The supplemental schedules have been subjected to the auditing procedures applied in the audit of the basic
financial statements for the year ended December 31, 20X2, and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.28]
Limited-Scope Audit in Current Year

Independent Auditor’s Report

Addressee:

We were engaged to audit the accompanying statement of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2 and the supplemental schedules of (1) Schedule H, line 4i—Schedule of Assets Held (At End of Year), (2) Schedule H, line 4j—Schedule of Reportable Transactions as of or for the year ended December 31, 20X2. These financial statements and supplemental schedules are the responsibility of the Plan’s management.

As permitted by 29 CFR 2520.103-8 of the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee (or custodian) of the Plan, except for comparing the information with the related information included in the 20X2 financial statements and the supplemental schedules. We have been informed by the plan administrator that the trustee (or custodian) holds the Plan’s investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee (or custodian) as of and for the year ended December 31, 20X2, that the information provided to the plan administrator by the trustee (or custodian) is complete and accurate.

Because of the significance of the information in the Plan’s 20X2 financial statements that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and supplemental schedules as of or for the year ended December 31, 20X2. The form and content of the information included in the financial statements and supplemental schedules, other than that derived from the information certified by the trustee (or custodian), have been audited by us in accordance with auditing standards generally accepted in the United States of America and, in our opinion, are presented in compliance with the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

We have audited the statement of net assets available for benefits of XYZ Pension Plan as of December 31, 20X1, and in our report dated May 20, 20X2, we expressed our opinion that such financial statement presents fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 20X1, in conformity with accounting principles generally accepted in the United States of America.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.29]
.16 Initial Limited-Scope Audit in Current Year, Prior Year Limited-Scope Audit Performed by Other Auditors

**Report of Independent Certified Public Accountants**

**Addressee:**

We were engaged to audit the accompanying statement of net assets available for benefits of ABC Company Profit-Sharing Plan (the “Plan”) as of December 31, 20X2, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2 and the supplemental Schedule H, line 4i—Schedule of Assets (Held at End of Year) as of December 31, 20X2. These financial statements and supplemental schedule are the responsibility of the Plan’s management. The financial statements of the plan as of December 31, 20X1 were audited by other auditors. As permitted by 29 CFR 2520.103-8 of the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974 (“ERISA”), the Plan administrator instructed the other auditors not to perform and they did not perform, any auditing procedures with respect to the information certified by the Trustee. Their report, dated May 20, 20X2, indicated that (a) because of the significance of the information that they did not audit, they were unable to, and did not, express an opinion on the financial statements taken as a whole and (b) the form and content of the information included in the financial statements other than that derived from the information certified by the Trustee, were presented in compliance with the Department of Labor’s Rules and Regulations for Reporting and Disclosure under ERISA.

As permitted by 29 CFR 2520.103-8 of the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the Plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in note E, which was certified by Bank & Trust Company, the trustee of the Plan, except for comparing such information with the related information included in the 20X2 financial statements and supplemental schedule. We have been informed by the Plan administrator that the trustee holds the Plan’s investment assets and executes investment transactions. The Plan administrator has obtained a certification from the trustee as of and for the year ended December 31, 20X2, that the information provided to the Plan administrator by the trustee is complete and accurate.

Because of the significance of the information in the Plan’s 20X2 financial statements and supplemental schedule that we did not audit, we are unable to, and do not, express an opinion on the accompanying 20X2 financial statements and supplemental schedule taken as a whole. The form and content of the information included in the 20X2 financial statements and supplemental schedule, other than that derived from the information certified by the trustee, have been audited by us in accordance with auditing standards generally accepted in the United States of America and, in our opinion, are presented in compliance with the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

____________________________________________________
[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.30]
.17 Limited Scope Audit—Change in Trustee

Report of Independent Certified Public Accountants

Addressee:

We were engaged to audit the accompanying statements of net assets available for benefits and of accumulated plan benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year ended December 31, 20X2, and the supplemental schedules of (1) Schedule H, line 4i—Schedule of Assets (Held at End of Year) as of December 31, 20X2, and (2) Schedule H, line 4j—Schedule of Reportable Transactions for the year ended December 31, 20X2. These financial statements and schedules are the responsibility of the Plan’s management.

As permitted by 29 CFR 2520.103-8 of the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the investment information summarized in Note X, which was certified by the ABC Bank and XYZ Trust Company, the trustees of the Plan, except for comparing such information with the related information included in the financial statements and supplemental schedules. We have been informed by the plan administrator that XYZ Trust Company held the Plan’s investment assets and executed investment transactions from July 1, 20X2 to December 31, 20X2, and that ABC Bank held the Plan’s investment assets and executed investment transactions as of December 31, 20X1 and for the period January 1, 20X1 to June 30, 20X2. The plan administrator has obtained certifications from the trustees as of and for the years ended December 31, 20X2 and 20X1, that the information provided to the plan administrator by the trustees is complete and accurate.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and supplemental schedules taken as a whole. The form and content of the information included in the financial statements and supplemental schedules, other than that derived from the investment information certified by the trustees, have been audited by us in accordance with auditing standards generally accepted in the United States and, in our opinion, are presented in compliance with the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.31]
.18 Audit of Multiemployer Defined Benefit Pension Plan With Scope Limitation

Independent Auditor’s Report

Addressee:

We were engaged to audit the statements of XYZ Multiemployer Pension Plan as of December 31, 20X2 and 20X1, and for the years then ended. These financial statements are the responsibility of the Plan’s management.

The Plan’s records and procedures are not adequate to assure the completeness of participants’ data on which contributions and benefit payments are determined, and the Board of Trustees did not engage us to perform, and we did not perform, any other auditing procedures with respect to participants’ data maintained by the sponsor companies or individual participants.

Because of the significance of the information that we did not audit, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.32]
.19 Modified Report—Omitted Information or Omitted Schedule Required Under DOL Regulations in a Limited Scope Engagement

Independent Auditor’s Report

Addressee:

[Same first and second paragraphs as the limited-scope report. See paragraph .13 in this section.]

The supplemental Schedule H, line 4i—Schedule of Assets (Held at End of Year) as of December 31, 20X2 that accompanies the Plan’s financial statements does not disclose the historical cost of certain nonparticipant directed plan assets held by the Plan trustee [or custodian]. Disclosure of this information is required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

or

The Plan has not presented the supplemental Schedule H, line 4j—Schedule of Reportable Transactions for the year ended December 31, 20X2. Disclosure of this information is required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and schedules taken as a whole. The form and content of the information included in the financial statements and schedules, other than that derived from the information certified by the trustee, have been audited by us in accordance with auditing standards generally accepted in the United States of America and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are presented in compliance with the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.16]
.20 Trust Established Under an Employee Benefit Plan

Independent Auditor’s Report

Addressee:

We have audited the accompanying statement of net assets of ABC Pension Trust as of December 31, 20X2, and the related statement of changes in net assets and trust balance for the year then ended. These financial statements are the responsibility of the Trust’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets of ABC Pension Trust as of December 31, 20X2, and the changes in its net assets and trust balance for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying statements are those of ABC Pension Trust, which is established under XYZ Pension Plan; the statements do not purport to present the financial status of XYZ Pension Plan. The statements do not contain certain information on accumulated plan benefits and other disclosures necessary for a fair presentation of the financial status of XYZ Pension Plan in conformity with accounting principles generally accepted in the United States of America. Furthermore, these statements do not purport to satisfy the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974 relating to the financial statements of employee benefit plans.

[Signature of Firm]

[City and State]
[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.33]
.21 Defined Benefit Plan Assuming Inadequate Procedures to Value Investments

Independent Auditor’s Report

Addressee:

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1 and of accumulated Plan benefits as of December 31, 20X2, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan’s internal control over financial reporting. Accordingly, we express no such opinion.] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note X, investments amounting to $______ (__ percent of net assets available for benefits) as of December 31, 20X2, have been valued at estimated fair value as determined by the Board of Trustees. We have reviewed the procedures applied by the trustees in valuing the securities and have inspected the underlying documentation. In our opinion, those procedures are not adequate to determine the fair value of the investments in conformity with accounting principles generally accepted in the United States of America. The effect on the financial statements and supplemental schedules of not applying adequate procedures to determine the fair value of the securities is not determinable.

In our opinion, except for the effects of the procedures used by the Board of Trustees to determine the valuation of investments as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 20X2 and information regarding the Plan’s net assets available for benefits as of December 31, 20X1, and the changes in its financial status for the year ended December 31, 20X2 in conformity with accounting principles generally accepted in the United States of America.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules [identify title of schedules and period covered] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan’s management. That additional information has been subjected to the auditing procedures applied in the audit of the basic financial statements for the year ended December 31, 20X2; and in our opinion, except for the effects of the valuation of investments, as described above, the additional information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature of Firm]
[City and State]
[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.38]
Report of Independent Registered Public Accounting Firm

Addressee:

We have audited the accompanying statements of net assets available for benefits of the ABC 401(k) plan (the Plan) as of December 31, 20X2 and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 20X2 and 20X1, and the changes in net assets available for benefits for the year ended December 31, 20X2 in conformity with U.S. GAAP.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Employee Benefit Plans, updated as of March 1, 2009, paragraph 13.19]

Note: Reporting Considerations for Nonaccelerated Filer Audit Reports. In an audit of a nonaccelerated filer that has determined it is not required to obtain, nor did it request the auditor to perform, an audit of internal control over financial reporting (under Section 404(b) of the Sarbanes-Oxley Act of 2002 and Item 308(b) of SEC Regulation S-K), firms may wish to consider expanding their audit report to include a statement that the purpose and extent of the auditor’s consideration of internal control over financial reporting were to determine that the nature, timing, and extent of tests to be performed are appropriate in the circumstances but were not sufficient to express an opinion on the effectiveness of internal control over financial reporting. Firms are not required to expand their audit report to include this statement. However, the SEC staff has indicated that if a firm chooses to expand its report to clarify this point, the language in Interpretation No. 18, “Reference to PCAOB Standards in an Audit Report on a Nonissuer,” of AU section 508, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1, AU sec. 9508 par. .89–.92), provides appropriate language to consider in an audit conducted in accordance with PCAOB standards. Accordingly, the scope section of the auditor’s report might be modified as follows:

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Plan is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes
examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As an alternative to the first additional sentence suggested by Interpretation 18 of AU section 508, a firm also might consider the following: A second alternative would be to use language from Auditing Interpretation No. 2, “Reports by Management on Internal Control Over Financial Reporting,” of AU section 550, Other Information in Documents Containing Audited Financial Statements (AICPA, Professional Standards, vol. 1, AU sec. 9550 par. .07–.11). Paragraph .10 of Interpretation No. 2 of AU section 550 states, “Although not required, the auditor may consider adding the following paragraph to the standard auditor’s report:

We were not engaged to examine management’s assertion about the effectiveness of [name of entity’s] internal control over financial reporting as of [date] included in the accompanying [title of management’s report] and accordingly, we do not express an opinion thereon.

[This information is from the Center for Audit Quality (CAQ)—CAQ Alert #2007-66—December 19, 2007.]

[The next page is 9851.]
AAM §9650

Reports on Financial Statements of Brokers and Dealers in Securities

.01 Unqualified Opinion on Financial Statements and Supplementary Schedules Required by the SEC

Independent Auditor’s Report

Addressee:

We have audited the accompanying [consolidated] statement of financial condition of Standard Stockbrokerage Co., Inc., [and Subsidiaries] (the Company) as of December 31, 20X8, and the related [consolidated] statements of income, changes in stockholders’ equity, changes in liabilities subordinated to claims of general creditors, and cash flows for the year then ended that you are filing pursuant to Rule 17a-5 under the Securities Exchange Act of 1934. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America.1 Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion.]2 An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

1 For audits conducted in accordance with Public Company Accounting Oversight Board (PCAOB) standards, PCAOB Auditing Standard No. 1, “References in Auditors’ Reports to the Standards of the Public Company Accounting Oversight Board (AICPA, PCAOB Standards and Related Rules, Rules of the Board, “Standards”), replaces this sentence with the following sentence: “We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States).” On May 14, 2004, the Securities and Exchange Commission (SEC) issued an interpretive release to help with the implementation of PCAOB Auditing Standard No. 1. See Release No. 33-8422 for more information. The release specifies that effective May 14, 2004, references in SEC rules and staff guidance and in the federal securities laws to generally accepted auditing standards (GAAS) or to specific standards under GAAS, as they relate to issuers, should be understood to mean the standards of the PCAOB, plus any applicable rules of the SEC. The guidance in this release is applicable only to auditors’ engagements that are governed by PCAOB rules. The PCAOB, for example, has not established particular auditing standards for nonissuer broker-dealers or investment advisers. This release is not applicable to such engagements and related filings.

The staff of the PCAOB published a series of questions and answers (Q&As) on PCAOB Auditing Standard No. 1. See the PCAOB Web site at www.pcaobus.org for more information.

In June 2004, the Auditing Standards Board (ASB) issued Interpretation No. 18, “Reference to PCAOB Standards in an Audit Report of a Nonissuer,” of AU section 508, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1, AU sec. 9508 par. 89–92), which provides reporting guidance for audits of nonissuers. Interpretation No. 18 provides guidance on the appropriate referencing of PCAOB auditing standards in audit reports when an auditor is engaged to perform the audit in accordance both with GAAS and PCAOB auditing standards. The ASB also is revising AU section 508 in light of the International Auditing and Assurance Standards Board’s recently exposed International Standard on Auditing The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements and PCAOB Auditing Standard No. 1. See the AICPA Web site at www.aicpa.org/Professional/Resources/Accounting+ and+Auditing/Audit+and+Attest+Standards for more information.

2 This optional wording may be added in accordance with Interpretation No. 17, “Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards,” of AU section 508 (AICPA, Professional Standards, vol. 1, AU sec. 9508 par. 85–88), which was issued by the ASB in June 2004 and provides reporting guidance for audits of nonissuers. Interpretation No. 17 addresses how auditors may expand their independent audit report to explain that their consideration of internal control was sufficient to provide the auditor sufficient understanding to plan the audit and determine the nature, timing and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. If this optional language is added, then the remainder of the paragraph would read as follows:

An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

AICPA Audit and Accounting Manual
In our opinion, the [consolidated] financial statements referred to above present fairly, in all material respects, the financial position of Standard Stockbrokerage Co., Inc. [and Subsidiaries] as of December 31, 20X8, and the results of its [their] operations and its [their] cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by Rule 17a-5 under the Securities Exchange Act of 1934. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Brokers and Dealers in Securities, updated as of May 1, 2008, appendix A]

Notes: SEC Regulation S-X Section 210.2-02 (17 CFR 210.2–.02) requires the accountant’s report to be dated, signed manually, indicate the city and state where issued, and identify without detailed enumeration the financial statements covered by the report.

Paragraphs .15–.16 of AAM section 9250 contain illustrative reports on internal control required by SEC Rule 17a-5.

* Paragraph .23 of AU section 339, Audit Documentation (AICPA, Professional Standards, vol. 1), states that the auditor’s report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements.
.02 Separate Report on Supplementary Schedules

Independent Auditor’s Report on Supplementary Information
Required by Rule 17a-5 of the Securities and Exchange Commission

Addressee:

We have audited the accompanying [consolidated] financial statements of Standard Stockbrokerage Co., Inc. [and Subsidiaries] as of and for the year ended December 31, 20X8, and have issued our report thereon dated February 15, 20X9. Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by Rule 17a-5 under the Securities Exchange Act of 1934. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature of Firm]

[City and State]
[Date]

[Source: AICPA Audit and Accounting Guide Brokers and Dealers in Securities, updated as of May 1, 2008, appendix B]

Note: This paragraph can be shown separately in the auditor-submitted document or as a separate paragraph, after the opinion paragraph, of the auditor’s standard report.

[The next page is 9901.]
AAM Section 9700

Reports for Investment Companies

.01 Unqualified Opinion on the Financial Statements of a Registered Investment Company

Report of Independent Registered Public Accounting Firm

Addressee:

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company, including the schedule of investments, as of December 31, 20X4, and the related statements of operations and cash flows1 for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended.2 These financial statements and financial highlights are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 20X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 20X4, the results of its operations and its cash flows for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended, in conformity with accounting principles generally accepted in the United States of America.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Investment Companies, updated as of May 1, 2009, paragraph 11.09]

Note: The reference to “and brokers” in the fourth sentence of the scope paragraph is not normally required if the investment company’s financial statements do not show an amount payable for securities purchased. When broker confirmations are not received and alternative procedures are performed, the sentence may be modified to read “and brokers or by other appropriate auditing procedures where replies from brokers were not received.” Also, if securities were physically inspected or subject

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1 Financial Accounting Standards Board Accounting Standards Codification 230-10-15-4 exempts highly liquid companies that meet specified conditions from the requirement to provide a statement of cash flows.

2 In an open-end fund’s registration statement, an auditor must opine on at least the most recent two of the five years of financial highlights presented in a registered investment company’s annual report. In the fund’s registration statement, the auditor must opine on all five years presented.
to other extended procedures for purposes of the audit, the report should be modified to state that those procedures were performed.

[Source: AICPA Audit and Accounting Guide Investment Companies, updated as of May 1, 2009, paragraph 11.10]
.02 Unqualified Opinion on the Financial Statements for a Multicolumnar Presentation of the Portfolios Constituting the Series

Report of Independent Registered Public Accounting Firm

Addressee:

We have audited the statements of assets and liabilities, including the schedules of investments, of XYZ Series Investment Company comprising the Foreign, Domestic Common Stock, Long-Term Bond, and Convertible Preferred Portfolios as of December 31, 20X4, and the related statements of operations and cash flows\(^3\) for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended. These financial statements and financial highlights are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 20X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of each of the portfolios constituting the XYZ Series Investment Company, as of December 31, 20X4, the results of their operations and cash flows for the year then ended, the changes in their net assets for each of the two years in the period then ended, and their financial highlights for each of the five years in the period then ended, in conformity with accounting principles generally accepted in the United States of America.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Investment Companies, updated as of May 1, 2009, paragraph 11.13]

\(^3\) See footnote 1.
.03 Unqualified Opinion on the Financial Statements Presenting One of the Portfolios or Entities Constituting the Series

Report of Independent Registered Public Accounting Firm

Addressee:

We have audited the accompanying statement of assets and liabilities, including the schedule of investments, of the Convertible Preferred Portfolio (one of the portfolios constituting the XYZ Series Investment Company [the Company]) as of December 31, 20X4, and the related statements of operations and cash flows for the year then ended, the statement of changes in net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended. These financial statements and financial highlights are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 20X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of the Convertible Preferred Portfolio of the XYZ Series Investment Company as of December 31, 20X4, and the results of its operations and its cash flows for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended, in conformity with accounting principles generally accepted in the United States of America.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Investment Companies, updated as of May 1, 2009, paragraph 11.14]

4 See footnote 1.
.04 Unqualified Opinion on the Financial Statements of a Nonregistered Investment Company

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company (the Company), including the schedule of investments, as of December 31, 20X4, and the related statements of operations, cash flows\(^5\) and changes in net assets, and the financial highlights for the year then ended. These financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America.\(^6\) Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 20X4, the results of its operations, its cash flows, changes in its net assets, and its financial highlights for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Investment Companies, updated as of May 1, 2009, paragraph 11.02]

\(^5\) See footnote 1.

\(^6\) AU section 508, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1), states that a basic element of the auditor's report is a statement that the audit was conducted in accordance with generally accepted auditing standards and an identification of the United States of America as the country of origin of those standards. Interpretation No. 14, "Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing," of AU section 508 (AICPA, Professional Standards, vol. 1, AU sec. 9508 par. .56–.59) states that if the audit also was conducted in accordance with the International Standards on Auditing, in their entirety, the auditor may so indicate in the auditor's report. This can be done by modifying this sentence as follows (new language is shown in italics): We conducted our audit in accordance with auditing standards generally accepted in the United States of America and in accordance with International Standards on Auditing.

[The next page is 10,001.]
AAM Section 10,000
Quality Control

These sample quality control documents are presented for illustrative purposes only. They are intended as an aid for users of this manual who may want points of departure when establishing their own quality control policies and procedures. These illustrations are neither all inclusive nor are they prescribed minimums. Auditors and accountants must consider the guidance in professional standards and should rely on their individual professional judgment in determining what may be needed in individual circumstances.

TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Quality Control—General</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>10,100</td>
<td>10,200 Practice Aid for Establishing and Maintaining a System of Quality Control for a CPA Firm’s Accounting and Auditing Practice—Revised for the Issuance of Statement on Quality Control Standards No. 7, A Firm’s System of Quality Control</td>
<td>.01-.03</td>
</tr>
</tbody>
</table>

Chapter 1: Overview of Statements on Quality Control Standards

Communication of Quality Control Policies and Procedures

Elements of a System of Quality Control

Leadership Responsibilities for Quality Within the Firm (the “Tone at the Top”)

Relevant Ethical Requirements

Acceptance and Continuance of Client Relationships and Specific Engagements

Human Resources

Engagement Performance

Monitoring

Documentation of Quality Control Policies and Procedures

Applying the Quality Control Standards to Four Hypothetical Firms

Chapter 2: System of Quality Control for a CPA Firm’s Accounting and Auditing Practice—Firm With Multiple Offices

Quality Control Policies and Procedures

Leadership Responsibilities for Quality Within the Firm (the “Tone at the Top”)

Relevant Ethical Requirements

Acceptance and Continuance of Client Relationships and Specific Engagements

Human Resources

Engagement Performance

Monitoring
<table>
<thead>
<tr>
<th>Section</th>
<th>Paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>10,200</td>
<td>Practice Aid for Establishing and Maintaining a System of Quality Control for a CPA Firm’s Accounting and Auditing Practice—Revised for the Issuance of Statement on Quality Control Standards No. 7, A Firm’s System of Quality Control—continued</td>
</tr>
</tbody>
</table>

Chapter 3: System of Quality Control for a CPA Firm’s Accounting and Auditing Practice—Firm With a Single Office ............................ 3.01-3.56

  - Quality Control Policies and Procedures .................................. 3.02-3.04
  - Leadership Responsibilities for Quality Within the Firm (the “Tone at the Top”) ................................................................. 3.05-3.10
  - Relevant Ethical Requirements .................................................. 3.11-3.17
  - Acceptance and Continuance of Client Relationships and Specific Engagements ................................................................. 3.18-3.24
  - Human Resources ........................................................................ 3.25-3.32
  - Engagement Performance ........................................................... 3.33-3.44
  - Monitoring .................................................................................. 3.45-3.56

Chapter 4: System of Quality Control for a CPA Firm’s Accounting Practice—Sole Practitioner .......................................................... 4.01-4.39

  - Quality Control Policies and Procedures .................................. 4.02-4.04
  - Leadership Responsibilities for Quality Within the Firm (the “Tone at the Top”) ................................................................. 4.05-4.08
  - Relevant Ethical Requirements .................................................. 4.09-4.13
  - Acceptance and Continuance of Client Relationships and Specific Engagements ................................................................. 4.14-4.20
  - Human Resources ........................................................................ 4.21-4.23
  - Engagement Performance ........................................................... 4.24-4.32
  - Monitoring .................................................................................. 4.33-4.39

Chapter 5: System of Quality Control for an Alternative Practice Structure .......................................................... 5.01-5.19

  - Quality Control Policies and Procedures .................................. 5.05
  - Relevant Ethical Requirements .................................................. 5.06-5.09
  - Human Resources ........................................................................ 5.10-5.13
  - Monitoring .................................................................................. 5.14-5.19

Appendix A: Statement on Quality Control Standards (SQCS) No. 7, A Firm’s System of Quality Control

Appendix B: Interpretation No. 101-14 of Rule 101

10,250 Statement on Quality Control Standards
10,280 Interpretation No. 101-14 of Rule 101, Independence
10,300 Sample Quality Control Forms .................................................. .01-.21

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[The next page is 10,101.]
AAM Section 10,100

Quality Control—General

AICPA Requirements

.01 ET section 57, Article VI—Scope and Nature of Services (AICPA, Professional Standards, vol. 2), of the AICPA’s Code of Professional Conduct states that “members should practice in firms that have in place internal quality-control procedures to ensure that services are competently delivered and adequately supervised.” A firm must establish a system of quality control designed to provide the firm with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements and that the firm or engagement partners issue reports that are appropriate in the circumstances. A system of quality control consists of policies designed to achieve these objectives and the procedures necessary to implement and monitor compliance with those policies.

.02 The AICPA issues Statements on Quality Control Standards (SQCSs) to establish standards and provide guidance to firms on establishing and maintaining a quality control system for their accounting and auditing practices. In October 2007, the AICPA issued SQCS No. 7, A Firm’s System of Quality Control (AICPA, Professional Standards, vol. 2, QC sec. 10). SQCS No. 7 was effective as of January 1, 2009, and superseded all extant SQCSs.

.03 Presented in AAM section 10,200 is Practice Aid for Establishing and Maintaining a System of Quality Control for a CPA Firm’s Accounting and Auditing Practice—Revised for the Issuance of Statement on Quality Control Standards No. 7, A Firm’s System of Quality Control. Following the practice aid in AAM section 10,300 are sample quality control forms to aid practitioners in implementing a quality control system.

[The next page is 10,201.]
AAM Section 10,200

Practice Aid for Establishing and Maintaining a System of Quality Control for a CPA Firm’s Accounting and Auditing Practice—Revised for the Issuance of Statement on Quality Control Standards No. 7, A Firm’s System of Quality Control

NOTICE TO READERS

This AICPA Audit and Accounting Practice Aid updates Establishing and Maintaining a System of Quality Control for a CPA Firm’s Accounting and Auditing Practice, which was issued in 2004. This practice aid is intended to help practitioners better understand and apply Statement on Quality Control Standards (SQCS) No. 7 issued by the AICPA. That standard is included in appendix A of this practice aid. This version of the practice aid, prepared by the Quality Control Standards Task Force, has been revised to incorporate new policies and procedures that a firm should consider including in its system of quality control to be responsive to the issuance of SQCS No. 7. The policies and procedures presented in this practice aid are illustrative, and firms are encouraged to consider them in designing and maintaining a system of quality control that is appropriate for their accounting and auditing practices. Some of the policies and procedures presented in this practice aid are not required by the SQCSs; however, they represent the views of the task force regarding best practices for a quality control system. Although this practice aid has been reviewed by the AICPA Audit and Attest Standards staff, it has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA and has no official or authoritative status.

The Sarbanes-Oxley Act of 2002 (Act) created the Public Company Accounting Oversight Board (PCAOB) and charged it with overseeing audits of issuers,1 as defined by the act. Under the act, the PCAOB’s duties include, among other things, establishing auditing, quality control, ethics, independence, and other standards relating to audits of issuers. This practice aid does not address the quality control requirements of the act, nor does it address the quality control requirements of PCAOB standards that must be followed by auditors of issuers. Auditors of issuers should follow these other standards and make changes to their firm’s quality control systems as necessary. Auditors of nonissuers who are engaged to report on audit engagements in accordance with PCAOB auditing standards also must report on those engagements in accordance with generally accepted auditing standards (GAAS). Interpretations No. 17, “Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards,” and No. 18, “Reference to PCAOB Standards in an Audit Report on a Nonissuer,” of AU section 508, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1, AU sec. 9508 par. .85–.88 and par. .89–.92, respectively), provide reporting guidance for audits of nonissuers when the auditor is asked to report in accordance with GAAS and PCAOB auditing standards.

Additional information about the PCAOB and the act can be obtained at the PCAOB Web site at www.pcaobus.org.

1 Paragraph 7 of Section 2, “Definitions,” of the Sarbanes-Oxley Act of 2002 states, “The term issuer means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 [15 U.S.C. 78c]), the securities of which are registered under section 12 of that act [15 U.S.C. 78l], or that is required to file reports under section 15(d) [15 U.S.C. 78o(d)], or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 [15 U.S.C. 77a et seq.], and that it has not withdrawn.”
Quality Control Standards Task Force (2007)

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Chapter 1:
Overview of Statements on Quality Control Standards

1.01 The objectives of a system of quality control are to provide a CPA firm with reasonable assurance\(^1\) that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements, and that the firm or engagement partners issue reports that are appropriate in the circumstances. SQCS No. 7, *A Firm’s System of Quality Control* (AICPA, *Professional Standards*, vol. 2, QC sec. 10), was issued by the Auditing Standards Board (ASB) of the AICPA in October 2007 and is effective for a firm’s accounting and auditing practice as of January 1, 2009. This standard supersedes all previously issued SQCSs.

1.02 A system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those policies. The nature, extent, and formality of a firm’s quality control policies and procedures will depend on various factors such as the firm’s size; the number and operating characteristics of its offices; the degree of authority allowed to, and the knowledge and experience possessed by, firm personnel; and the nature and complexity of the firm’s practice.

Communication of Quality Control Policies and Procedures

1.03 The firm should communicate its quality control policies and procedures to its personnel. Most firms will find it appropriate to communicate their policies and procedures in writing and distribute, or make available electronically, them to all professional personnel.

1.04 Effective communication includes the following:
- A description of quality control policies and procedures and the objectives they are designed to achieve
- The message that each individual has a personal responsibility for quality
- A requirement for each individual to be familiar with and to comply with these policies and procedures

Effective communication also includes procedures for personnel to communicate their views or concerns on quality control matters to the firm’s management.

Elements of a System of Quality Control

1.05 A firm’s system of quality control should include policies and procedures that address each of the following elements of quality control identified in SQCS No. 7:
- Leadership responsibilities for quality within the firm (the “tone at the top”)
- Relevant ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Human resources
- Engagement performance
- Monitoring

1.06 The elements of quality control are interrelated. For example, a firm continually assesses client relationships to comply with relevant ethical requirements, including independence, integrity, and objectivity, and policies and procedures related to the acceptance and continuance of client relationships and specific engagements. Similarly, the human resources element of quality control encompasses criteria related to

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\(^1\) The term *reasonable assurance*, which is defined as a high, but not absolute, level of assurance, is used because absolute assurance cannot be attained. *Statement on Quality Control Standards* (SQCS) No. 7, *A Firm’s System of Quality Control* (AICPA, *Professional Standards*, vol. 2, QC sec. 10), states, “Any system of quality control has inherent limitations that can reduce its effectiveness.”

AICPA Audit and Accounting Manual

AAM §10,200 1.06
professional development, hiring, advancement, and assignment of firm personnel to engagements, all of which affect policies and procedures related to engagement performance. In addition, policies and procedures related to the monitoring element of quality control enable a firm to evaluate whether its policies and procedures for each of the other five elements of quality control are suitably designed and effectively applied.

1.07 If a firm merges, acquires, sells, or otherwise changes a portion of its practice, the surviving firm evaluates and, as necessary, revises, implements, and maintains firm-wide quality control policies and procedures that are appropriate for the changed circumstances.

Leadership Responsibilities for Quality Within the Firm (the “Tone at the Top”)

1.08 The objective of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. The firm should establish and maintain the following policies and procedures to satisfy this objective:

- Require the firm’s leadership (managing partner, board of managing partners or CEO, or equivalent) to assume ultimate responsibility for the firm’s system of quality control.
- Assign management responsibilities so that commercial considerations do not override the quality of the work performed.
- Assign operational responsibility for the firm’s quality control system to personnel who have sufficient and appropriate experience and ability to identify and understand quality control issues and to develop appropriate policies and procedures, as well as the necessary authority to implement those policies and procedures.
- Design policies and procedures addressing performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel to demonstrate the firm’s overarching commitment to the objectives of the system of quality control.
- Devote sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.

Relevant Ethical Requirements

1.09 The objective of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Establishing and maintaining policies such as the following ordinarily would satisfy this objective:

- Require that personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the U.S. Government Accountability Office (GAO), and any other applicable regulators.
- Establish procedures to communicate independence requirements to firm personnel and, where applicable, others subject to them.
- Establish procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.
- Require that the firm withdraw from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.
• Require written confirmation, at least annually, of compliance with the firm’s policies and procedures on independence from all firm personnel required to be independent by relevant requirements.

• Establish procedures for confirming the independence of another firm or firm personnel in associated member firms who perform part of the engagement. This would apply to national firm personnel, foreign firm personnel, and foreign-associated firms.\(^2\)

• Require the rotation of personnel for audit or attest engagements where regulatory or other authorities require such rotation after a specified period.

Acceptance and Continuance of Client Relationships and Specific Engagements

1.10 The objective of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm’s client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client’s management could reflect the reliability of the client’s accounting records and financial representations and, therefore, affect the firm’s reputation or involvement in litigation. A firm’s policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

• has considered the integrity of the client, including the identity and business reputation of the client’s principal owners, key management, related parties, and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;

• is competent to perform the engagement and has the capabilities and resources to do so;

• can comply with legal and ethical requirements; and

• has reached an understanding with the client regarding the services to be performed.

1.11 This objective ordinarily should be satisfied before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client by establishing and maintaining policies such as the following:

• Evaluate factors that have a bearing on management’s integrity and consider the risk associated with providing professional services in particular circumstances.\(^3\)

• Evaluate whether the engagement can be completed with professional competence; undertake only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluate, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.

• Obtain an understanding, preferably in writing, with the client regarding the services to be performed.

• Establish procedures on withdrawal from an engagement or from both the engagement and the client relationship, including procedures for dealing with information that would have caused the firm to decline an engagement if the information had been available earlier.

• Require documentation of how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.

\(^2\) A foreign-associated firm is a firm domiciled outside of the United States and its territories that is a member of, correspondent with, or similarly associated with an international firm or international association of firms.

\(^3\) Such considerations would include the risk of providing professional services to significant clients or to other clients for which the practitioner’s objectivity or the appearance of independence may be impaired. In broad terms, the significance of a client to a member or a firm refers to relationships that could diminish a practitioner’s objectivity and independence in performing attest services. Examples of factors to consider in determining the significance of a client to an engagement partner, office, or practice unit include (a) the amount of time the partner, office, or practice unit devotes to the engagement, (b) the effect on the partner’s stature within the firm as a result of his or her service to the client, (c) the manner in which the partner, office, or practice unit is compensated, or (d) the effect that losing the client would have on the partner, office, or practice unit.
Human Resources

1.12 The objective of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (a) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (b) to enable the firm to issue reports that are appropriate in the circumstances. Establishing and maintaining policies such as the following ordinarily would satisfy this objective:

- Recruit and hire personnel of integrity who possess the characteristics that enable them to perform competently.
- Determine capabilities and competencies required for an engagement, especially for the engagement partner, based on the characteristics of the particular client, industry, and kind of service being performed. Specific competencies necessary for an engagement partner are discussed in paragraph 45 of SQCS No. 7.
- Determine the capabilities and competencies possessed by personnel.
- Assign the responsibility for each engagement to an engagement partner.
- Assign personnel based on the knowledge, skills, and abilities required in the circumstances and the nature and extent of supervision needed.
- Have personnel participate in general and industry-specific continuing professional education and professional development activities that enable them to accomplish assigned responsibilities and satisfy applicable continuing professional education requirements of the AICPA, state boards of accountancy, and other regulators.
- Select for advancement only those individuals who have the qualifications necessary to fulfill the responsibilities they will be called on to assume.

Engagement Performance

1.13 The objectives of the engagement performance element of quality control are to provide the firm with reasonable assurance (a) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements and (b) that the firm or the engagement partner issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed.

1.14 The objectives of the engagement performance element of quality control ordinarily would be satisfied by establishing and maintaining policies such as the following:

- Plan all engagements to meet professional, regulatory, and the firm’s requirements.
- Perform work and issue reports and other communications that meet professional, regulatory, and the firm’s requirements.
- Require that work performed by other team members be reviewed by qualified engagement team members, which may include the engagement partner, on a timely basis.
- Require the engagement team to complete the assembly of final engagement files on a timely basis.
- Establish procedures to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.
- Require the retention of engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.
• Require that
  — consultation take place when appropriate (for example, when dealing with complex, unusual, unfamiliar, difficult, or contentious issues);
  — sufficient and appropriate resources be available to enable appropriate consultation to take place;
  — all the relevant facts known to the engagement team be provided to those consulted;
  — the nature, scope, and conclusions of such consultations be documented; and
  — the conclusions resulting from such consultations be implemented.

• Require that
  — differences of opinion be dealt with and resolved;
  — conclusions reached are documented and implemented; and
  — the report not be released until the matter is resolved.

• Require that
  — all engagements be evaluated against the criteria for determining whether an engagement quality control review should be performed;
  — an engagement quality control review be performed for all engagements that meet the criteria; and
  — the review be completed before the report is released.

• Establish procedures addressing the nature, timing, extent, and documentation of the engagement quality control review.

• Establish criteria for the eligibility of engagement quality control reviewers.

**Monitoring**

1.15 The objective of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm’s quality control system, and a firm’s compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

• Adherence to professional standards and regulatory and legal requirements
• Whether the quality control system has been appropriately designed and effectively implemented
• Whether the firm’s quality control policies and procedures have been operating effectively so that reports issued by the firm are appropriate in the circumstances

1.16 The objective of the monitoring element of quality control ordinarily would be satisfied by establishing and maintaining policies such as the following:

• Assign responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility.
• Assign performance of the monitoring process to competent individuals.
• Require the performance of monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm’s quality control policies and procedures. Monitoring procedures consist of the following:
— Review of selected administrative and personnel records pertaining to the quality control elements
— Review of engagement working papers, reports, and clients’ financial statements
— Summarization of the findings from the monitoring procedures, at least annually, and consideration of the systemic causes of findings that indicate that improvements are needed
— Determination of any corrective actions to be taken or improvements to be made with respect to the specific engagements reviewed or the firm’s quality control policies and procedures
— Communication of the identified findings to appropriate firm management personnel
— Consideration of findings by appropriate firm management personnel who should also determine that any actions necessary, including necessary modifications to the quality control system, are taken on a timely basis
— Assessment of
  a. The appropriateness of the firm’s guidance materials and any practice aids;
  b. New developments in professional standards and regulatory and legal requirements and how they are reflected in the firm’s policies and procedures where appropriate;
  c. Compliance with policies and procedures on independence;
  d. The effectiveness of continuing professional development, including training;
  e. Decisions related to acceptance and continuance of client relationships and specific engagements; and
  f. Firm personnel’s understanding of the firm’s quality control policies and procedures and implementation thereof.

• Communicate at least annually, to relevant engagement partners and other appropriate personnel, deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.
• Communicate the results of the monitoring of its quality control system process to relevant firm personnel at least annually.
• Establish procedures designed to provide the firm with reasonable assurance that it deals appropriately with the following. This includes establishing clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisal and documenting complaints and allegations and the responses to them:
  — Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements
  — Allegations of noncompliance with the firm’s system of quality control
  — Deficiencies in the design or operation of the firm’s quality control policies and procedures, or noncompliance with the firm’s system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations
• Require appropriate documentation to provide evidence of the operation of each element of its system of quality control. The form and content of documentation evidencing the operation of each of the elements of the system of quality control is a matter of judgment and depends on a number of factors, including the following, for example:
  — The size of the firm and the number of offices
  — The nature and complexity of the firm’s practice and organization
• Require retention of documentation providing evidence of the operation of the system of quality control for a period of time sufficient to permit those performing monitoring procedures and peer review to evaluate the firm’s compliance with its system of quality control, or for a longer period if required by law or regulation.

1.17 Some of the monitoring procedures discussed in the previous list may be accomplished through the performance of the following:

• Engagement quality control review
• Postissuance review of engagement working papers, reports, and clients’ financial statements for selected engagements
• Inspection procedures

Documentation of Quality Control Policies and Procedures

1.18 The firm should document each element of its system of quality control. The extent of the documentation will depend on the size, structure, and nature of the firm’s practice. Documentation may be as simple as a checklist of the firm’s policies and procedures or as extensive as practice manuals.

Applying the Quality Control Standards to Four Hypothetical Firms

1.19 Subsequent chapters in this practice aid present four different hypothetical firms and the quality control policies and procedures each firm implements to address each of the quality control elements. Following is a description of those firms and their characteristics:

• Multioffice CPA Firm has 10 offices in 3 states and is centrally managed. It has approximately 15 partners and 100 professionals. Its accounting and auditing practice has a concentration of financial institution clients for which it performs audit and attest services. Multioffice CPA Firm has no issuer clients. (chapter 2)

• Single office CPA Firm has 1 office, 3 partners, and 10 professionals. Its accounting and auditing practice has a concentration of employee benefit plan audits. Single office CPA Firm has no issuer clients. (chapter 3)

• Sole Practitioner, CPA, is a sole owner who has no professional staff and occasionally hires per diem professionals. Her accounting practice consists only of engagements subject to Statements on Standards for Accounting and Review Services (SSARSs). (chapter 4) (Note: Sole practitioners who perform audit and attest engagements should refer to chapter 3)

• Closely Aligned CPA Firm and Non-CPA-Owned Entity are organized in an alternative practice structure, which is a nontraditional structure in the practice of public accounting consisting of an attest and a nonattest portion of the practice. The attest portion is conducted through a firm, Closely Aligned CPA Firm, owned and controlled by CPAs. The nonattest portion is conducted through a separate entity, Non-CPA-owned Entity, owned and controlled by individuals who are not CPAs. (chapter 5)

1.20 The policies and procedures described in each chapter are those that a firm of a similar size and type may consider establishing and maintaining. The policies and procedures used by an actual firm need not necessarily include nor be limited to all those used by the illustrative firms.

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4 Inspections is a retrospective evaluation of the adequacy of the firm’s quality control policies and procedures, its personnel’s understanding of those policies and procedures, and the extent of the firm’s compliance with them. Although monitoring procedures are meant to be ongoing, they may include inspection procedures performed at a fixed point in time. Monitoring is a broad concept; inspection is one specific type of monitoring procedure.
Chapter 2:
System of Quality Control for a CPA Firm’s Accounting and Auditing Practice—Firm With Multiple Offices

2.01 This chapter describes how a CPA firm that has multiple offices (Multioffice CPA Firm) implements each element of quality control in its accounting and auditing practice. Multioffice CPA Firm is a hypothetical firm that has 10 offices in 3 states and is centrally managed. Multioffice CPA Firm has 15 partners, 100 professionals, and a concentration of financial institution clients for which it performs audit and attest services. The firm uses practice aids that have been subjected to peer review in accordance with standards established by the AICPA. These practice aids are supplemented by oral and written communications from the firm’s partners. It has no issuer clients.¹

Quality Control Policies and Procedures

2.02 The firm’s system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those policies. The policies and procedures are required to be documented. Multioffice CPA Firm documents its system of quality control by preparing a document that comprehensively describes policies and procedures established and maintained for each element of quality control. Multioffice CPA Firm reviews the documentation at least annually and updates it as necessary.

2.03 The firm should communicate its quality control policies and procedures to its personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve
- The message that each individual has a personal responsibility for quality

2.04 Multioffice CPA Firm communicates these policies and procedures in writing and makes the documentation available electronically to all professional personnel. Multioffice CPA Firm requires each individual to be familiar with and to comply with these policies and procedures. Multioffice CPA Firm also includes procedures for personnel to communicate their views or concerns on quality control matters to partners.

Leadership Responsibilities for Quality Within the Firm (the “Tone at the Top”)

2.05 The objective of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. Multioffice CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 2.06–10.

2.06 Policy 1: The firm’s managing partner assumes ultimate responsibility for the firm’s system of quality control. Multioffice CPA Firm implements this policy through the following procedures:

- Having the managing partner accept overall responsibility for the firm’s system of quality control and promoting a quality-oriented culture by sending clear, consistent, and frequent messages through e-mails, letters, and recordings
- Having a mission statement that includes the firm’s core values and the importance of quality
- Informing personnel that failure to adhere to the firm’s policies and procedures regarding performance quality and commitment to ethical principles may result in disciplinary action

¹ If Multioffice CPA Firm were to be engaged to perform audit services for an issuer, it might need to revise its quality control policies and procedures to comply with Public Company Accounting Oversight Board (PCAOB) standards and to reflect Securities and Exchange Commission (SEC) requirements applicable to audits of issuers.
2.07 Policy 2: The firm assigns management responsibilities so that commercial considerations do not override the quality of the work performed. Multioffice CPA Firm implements this policy through the following procedures:

- Having the managing partner continually evaluate client relationships and specific engagements so that commercial considerations do not override the objectives of the system of quality control
- Emphasizing to all personnel that fee considerations and scope of services should not infringe upon quality work

2.08 Policy 3: The firm assigns operational responsibility for the firm’s quality control system to personnel who have sufficient and appropriate experience and ability to identify and understand quality control issues and to develop appropriate policies and procedures, as well as the necessary authority to implement those policies and procedures. Multioffice CPA Firm implements this policy through the following procedures:

- Designating a quality control partner with overall operational responsibility for developing and implementing appropriate policies and procedures for the firm’s quality control system
- Designating a quality control individual for each office

2.09 Policy 4: The firm designs procedures addressing performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel to demonstrate the firm’s overarching commitment to the objectives of the system of quality control. Multioffice CPA Firm implements this policy through the following procedures:

- Designing and implementing performance evaluation and advancement systems that (a) reward partners and staff involved in the accounting and auditing practice for the quality of their work and their compliance with professional standards and (b) include partner performance peer evaluations
- Establishing a compensation system that provides incentives to accounting and auditing partners and senior-level employees for the quality of their accounting and auditing work. The compensation system does the following:
  - Takes into consideration firm feedback based on monitoring results and peer reviews of the work performed
  - Rewards partners and personnel for timely (a) identification of significant and emerging accounting and auditing issues and (b) consultation with firm experts

2.10 Policy 5: The firm devotes sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures. Multioffice CPA Firm implements this policy through the following procedures:

- Providing the designated quality control partner with sufficient time, authority, and resources to develop, implement, and maintain the firm’s quality control policies and procedures
- Providing the firm’s quality control documentation to personnel when they are initially hired and reviewing the documentation with them
- Reviewing the firm’s quality control policies and procedures with personnel at firm training sessions at least annually

Relevant Ethical Requirements

2.11 The objective of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Multioffice CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 2.12–.18.
2.12 Policy 1: Personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the GAO, and any other applicable regulators. Multioffice CPA Firm implements this policy through the following procedures:

- Assigning one of its partners the responsibility of responding to questions, resolving matters, and determining the circumstances for which consultation with sources outside the firm is required for matters related to independence, integrity, and objectivity
- Identifying circumstances for which documentation of the resolution of matters is appropriate
- Maintaining a current list of (a) all entities with which firm personnel are prohibited from having a financial or business relationship and (b) all activities in which the firm is prohibited from engaging, as defined in the firm’s independence policies
- Establishing clear and concise written independence guidance covering relationships and activities that impair independence, including but not limited to investments, loans, brokerage accounts, business relationships, employment relationships, and fee arrangements

2.13 Policy 2: The firm establishes procedures to communicate independence requirements to firm personnel and, where applicable, others subject to them. Multioffice CPA Firm implements this policy through the following procedures:

- Having the managing partner (through e-mails, letters, or recordings) emphasize the concepts of independence, integrity, and objectivity in the firm’s professional development meetings, in the acceptance and continuance of clients and engagements, and in the performance of engagements. Because Multioffice CPA Firm has a concentration of financial institution clients, this also includes discussing the applicability of these concepts to engagements for financial institutions, such as the prohibition against any member of the engagement team having a “nongrandfathered” loan with the institution, and the types of nonattest services that could affect independence.
- Requiring periodic independence and ethics training for all professional personnel. Such training covers the firm’s independence and ethics policies and the independence and ethics requirements of all applicable regulators.
- Providing frequent reminders of professional responsibilities to personnel, such as avoiding behavior that might be perceived as impairing their independence or objectivity.
- Informing personnel on a timely basis of those entities to which independence policies apply by doing the following:
  - Preparing and maintaining a list of entities with which firm personnel are prohibited from having a financial or business relationship
  - Making the list available to personnel so they may evaluate their independence (including personnel new to the firm or an office)
  - Notifying personnel of changes in the list

2.14 Policy 3: The firm establishes procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards. Multioffice CPA Firm implements this policy through the following procedures:

- Assigning a partner who is not otherwise associated with the engagement, or who practices in an office other than the office that performs the attest engagement, to review the engagement
- Requiring approval of the assignment of engagement personnel by another partner or manager
- Rotating engagement partners periodically

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2 Examples of prohibited activities include providing certain valuation and information technology services to an audit client. See the rules of specific standard-setters to determine the extent and relevance of any prohibition.
• Establishing additional procedures that provide safeguards when the firm performs audit or other attest work for (a) significant clients or (b) clients at which partners or other senior personnel are offered key management positions, or accept offers of employment, by utilizing the procedures contained in the AICPA Code of Professional Conduct, paragraphs .01 and .04 of ET section 100, Conceptual Framework for AICPA Independence Standards (AICPA, Professional Standards, vol. 2)

• Designating a senior-level partner to be responsible for overseeing the adequate functioning of the firm’s independence policies

• Implementing a system to identify investment holdings of partners and managers that might impair independence

• Requiring all professionals to report, on a timely basis when identified, apparent violations of independence, integrity, or objectivity policies involving themselves, their spouses, or their dependents and the corrective actions taken or proposed to be taken

• Establishing a requirement for all professional personnel to notify the managing partner in each office of any potential activities that might impair independence or violate ethics rules, including services provided to entities with which firm personnel are prohibited from having a business relationship

• Establishing a program that protects professional personnel who report potential ethics or independence violations to the proper parties in compliance with firm policy

• Requiring the managing partner in each office, or a person designated by the managing partner, to periodically review unpaid fees from clients to ascertain whether any outstanding amounts impair the firm’s independence

• Developing guidance that sets forth the consequences for professional personnel who violate the firm’s independence policies and procedures, including engaging in activities with entities with which firm personnel are prohibited from having a business relationship

• Requiring all professional personnel to review the list of entities with which firm personnel are prohibited from having a business relationship before a professional or the spouse or dependent of a professional obtains a security or financial interest in an entity

• Establishing criteria that determine the need for safeguards for engagements where monitoring procedures or peer review have identified weaknesses in previous years or the same senior personnel have been used for five years or more on an audit or attestation engagement

• Documenting any safeguards applied to eliminate threats to independence or reduce them to an acceptable level

• Promptly communicating identified breaches of these policies and procedures, and the required corrective actions, to (a) the engagement partner who, with the firm, needs to address the breach and (b) other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action

• Obtaining confirmation from the engagement partner and other relevant personnel that the required corrective actions have been taken

2.15 Policy 4: The firm withdraws from engagements if effective safeguards to reduce threats to independence to an acceptable level cannot be applied. Multioffice CPA Firm implements this policy through the following procedures:

• Consulting within the firm and, if necessary, with legal counsel and other parties when the firm believes that effective safeguards to reduce threats to independence to an acceptable level cannot be applied

• Withdrawing from engagements when effective safeguards to reduce threats to independence to an acceptable level cannot be applied
2.16 Policy 5: The firm obtains written confirmation, at least annually, of compliance with its policies and procedures on independence from all firm personnel required to be independent by relevant requirements. Multioffice CPA Firm implements this policy through the following procedures:

- Obtaining written representations from personnel, upon hire and on an annual basis, stating that they have read the firm’s independence, integrity, and objectivity policies, understand the applicability of those policies to their activities, and have complied with the requirements of those policies since their last representation (such written representations are accompanied by the most current list of all entities with which firm personnel are prohibited from having a financial or business relationship)
- Assigning responsibility to the firm’s quality-control partner for obtaining such written representations, reviewing independence compliance files for completeness, and resolving reported exceptions
- Requiring the engagement partner to sign a step in the engagement program attesting to compliance with independence requirements that apply to the engagement

2.17 Policy 6: The firm establishes procedures for confirming the independence of another firm or firm personnel in associated member firms who perform part of an engagement. Multioffice CPA Firm implements this policy through the following procedures:

- Describing in its policies and procedures manual the form and content of independence representations, and frequency with which they are to be obtained
- Requiring that such representations be documented

2.18 Policy 7: The firm rotates personnel for audit or attest engagements where regulatory or other authorities require such rotation after a specified period. Multioffice CPA Firm implements this policy by having the quality control partner monitor regulatory requirements for financial institutions and other entities and notifying partners of the need for rotation. Multioffice CPA Firm has decided to rotate partners assigned to audit financial institutions every five years.

Acceptance and Continuance of Client Relationships and Specific Engagements

2.19 The objective of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm’s client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client’s management could reflect the reliability of the client’s accounting records and financial representations and, therefore, affect the firm’s reputation or involvement in litigation. A firm’s policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

- has considered the integrity of the client, including the identity and business reputation of the client’s principal owners, key management, related parties, and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;
- is competent to perform the engagement and has the capabilities and resources to do so;
- can comply with legal and ethical requirements; and
- has reached an understanding with the client regarding the services to be performed.

2.20 Multioffice CPA Firm satisfies this objective, both with respect to the initial period for which the firm is performing its service and for subsequent periods, by establishing and maintaining the policies and procedures described in paragraphs 2.21–25.
2.21 Policy 1: The firm evaluates factors that have a bearing on management’s integrity and considers the risk associated with providing professional services in particular circumstances. Multioffice CPA Firm implements this policy through the following procedures:

- Developing and maintaining a manual that contains policies and procedures related to the acceptance of prospective clients and the continuance of existing clients. Such policies and procedures state that the firm’s clients should not present undue risks to the firm, including damage to the firm’s reputation.
- Advising professional personnel that they are expected to be familiar with the firm’s policies and procedures for the acceptance and continuance of clients.
- Obtaining and evaluating relevant information before accepting or continuing any client. The following are examples of such information:
  - The nature and purpose of the services to be provided and management’s understanding thereof.
  - The identity of the client’s principal owners, key management, related parties, and those charged with its governance.
  - The nature of the client’s operations, including its business practices, from sources such as annual reports, interim financial statements, reports to regulators, enforcement actions by regulators, and income tax returns.
  - Information obtained from inquiries of third parties about the client, its principal owners, key management, and those charged with governance that may have a bearing on evaluating the client. Examples of such third parties are bankers, factors, legal counsel, credit services, investment bankers, underwriters, and other members of the financial or business community who may have applicable knowledge. Inquiries also might be made regarding management’s attitude toward compliance with regulators or legislative requirements and the presence of control deficiencies, especially those that management is unwilling to correct.
- Communicating with the predecessor accountant or auditor when required or recommended by professional standards. This communication also includes inquiries regarding the nature of any disagreements and whether there is evidence of opinion shopping.
- Assessing management’s commitment to implementing and maintaining effective internal control.
- Assessing management’s commitment to the appropriate application of generally accepted accounting principles (GAAP).
- Conducting a background check of the business, its officers, and the person(s) in question by using an investigative firm and evaluating the information obtained regarding management’s integrity. Background checks are conducted when the firm is unable to obtain sufficient information about the prospective client after completing the steps listed previously, or when there is an indication that management or someone affiliated with the prospective client may be less than reputable.
- Evaluating the risk of providing services to significant clients or to other clients for which the firm’s independence or the appearance of independence may be impaired. In broad terms, the significance of a client to a firm refers to relationships that could diminish a practitioner’s objectivity and independence in performing attest services. In determining the significance of a client, the firm considers (a) the amount of time the partner devotes to the engagement, (b) the effect on the partner’s stature within the firm as a result of his or her service to the client, (c) the manner in which the partner is compensated, and (d) the effect that losing the client would have on the partner and the firm.

2.22 Policy 2: The firm evaluates whether the engagement can be completed with professional competence; undertakes only those engagements for which the firm has the capabilities, resources, and professional competence to
complete; and evaluates, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued. Multioffice CPA Firm implements this policy through the following procedures:

- Evaluating whether the following are in place:
  - The practice office has sufficient personnel who have obtained or can reasonably expect to obtain the knowledge and expertise necessary to perform the engagement, including relevant regulatory or reporting requirements.
  - Specialists are available if needed, through, for example, the resources of another practice office or alternative source.
  - The firm is able to complete the engagement within the reporting deadline.

- Defining high-risk engagements.

- Specifying conditions that trigger the requirement between annual audits to reevaluate a client or engagement. The following are examples of such conditions:
  - Significant changes in the client, such as a major change in ownership, senior client personnel, directors, advisers, the nature of the business, or its financial stability.
  - Changes in the nature or scope of the engagement, such as an initial public offering or a request to step down from an audit to a review engagement.
  - Changes in the composition or strategic focus of the firm, such as the inability to replace the loss of key personnel who are particularly knowledgeable about a specialized industry or a decision by Multioffice CPA firm to discontinue services to clients in a particular industry.
  - The existence of conditions that would have caused the firm to reject the engagement had such conditions existed at the time of the initial acceptance, such as aggressive earnings management, unreliable processes for developing accounting estimates, questionable estimates by management, questions regarding the entity’s ability to continue as a going concern, and other factors that may increase the risk of being associated with the client.
  - The client’s delinquency in paying fees. (This may also affect the firm’s independence.)
  - Engagements for entities operating in highly specialized or regulated industries, such as financial institutions, governmental entities, and employee benefit plans.
  - Engagements for entities in the development stage.
  - Engagements in which the client has ignored prior recommendations, such as recommendations that address deficiencies in internal control.

- Obtaining relevant information to determine whether the relationship should be continued and establishing the frequency with which client continuance evaluations should be made.

- Evaluating the information obtained regarding acceptance or continuance of a client or engagement through the following activities:
  - The engagement partner assesses the information obtained about the client or the specific engagement, including information about the significance of the client to the firm, and makes a recommendation about whether the client or engagement should be accepted or continued.
  - The engagement partner completes a client acceptance form and submits it to the managing partner of the practice office for approval.
  - The engagement partner signs a step in the planning program noting that he or she has considered whether the client should be continued, and if conditions exist that trigger the requirement between annual audits to reevaluate a client or engagement, prepares a form documenting his or her rationale and conclusion regarding client continuance.
— The partner responsible for the quality control function assesses and approves the recommendation made by the engagement partner. In certain defined circumstances, such as high-risk engagements, acceptance or continuance decisions also may require approval of the firm’s managing partner.

- Establishing procedures for dealing with information that would have caused the firm to decline the engagement if the information had been available earlier.

2.23 Policy 3: The firm obtains an understanding with the client regarding the services to be performed. Multioffice CPA Firm implements this policy by requiring that for all engagements, the firm prepare a written engagement letter documenting the understanding with the client and obtain the client’s signature on that letter, thus minimizing the risk of misunderstandings regarding the nature, scope, and limitations of the services to be performed.

2.24 Policy 4: The firm establishes procedures on withdrawal from an engagement or from both the engagement and the client relationship. Multioffice CPA Firm implements this policy through the following procedures:

- Discussing with the appropriate level of the client’s management and those charged with its governance the appropriate action that the firm might take based on the relevant facts and circumstances
- Considering whether there is a professional, regulatory, or legal requirement for the firm to remain in place or for the firm to report to regulatory authorities the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal
- Discussing with the appropriate level of the client’s management and those charged with its governance withdrawal from the engagement, or from both the engagement and the client relationship, if the firm determines that it is appropriate to withdraw

2.25 Policy 5: The firm documents how issues relating to acceptance or continuance of client relationships and specific engagements were resolved. Multioffice CPA Firm implements this policy by documenting, in a memorandum to the engagement files, significant issues, consultations, conclusions, and the basis for the conclusions relating to acceptance or continuance of client relationships and specific engagements.

Human Resources

2.26 The objective of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (a) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (b) to enable the firm to issue reports that are appropriate in the circumstances. Multioffice CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 2.27–33.

2.27 Policy 1: Personnel who are hired possess the characteristics that enable them to perform competently. Multioffice CPA Firm implements this policy by maintaining firm-wide hiring standards and evaluating the firm’s personnel needs, including the following:

- Designating a partner or other qualified individual in each office to be responsible for evaluating the overall personnel needs in that practice office and establishing hiring objectives based on factors such as existing clientele, anticipated growth, personnel turnover, and individual advancement
- Developing and maintaining personnel policies and procedures that identify attributes, achievements, and experiences desired in entry-level and experienced personnel
- Establishing criteria for evaluating personal characteristics such as integrity, competence, and motivation
- Establishing guidelines for the additional procedures to be performed when hiring experienced personnel, such as performing background checks and inquiring about any outstanding regulatory actions
• Preparing budgets that identify personnel needs at all levels
• Identifying sources of employment candidates such as universities and executive recruiters
• Selecting and training the individuals who will be interviewing candidates or otherwise participating in the hiring process
• Summarizing and evaluating the results of the hiring process for each candidate, including approval by the managing partner, or a person designated by the managing partner, of all hiring decisions

2.28 Policy 2: The firm determines capabilities and competencies required for an engagement, including those required of the engagement partner. Multioffice CPA Firm implements this policy by specifying the competencies that the engagement partner for an accounting, auditing, or attest engagement (or other person responsible for supervising and signing or authorizing someone to sign the firm’s report on such engagements) should possess. Such competencies include having an understanding of the following:

• The role of the firm’s system of quality control and the AICPA Code of Professional Conduct, both of which play critical roles in ensuring the integrity of the accounting, auditing, and attest function to users of reports.
• The performance, supervision, and reporting aspects of the engagement, which ordinarily are gained through training or participation in similar engagements.
• The industry in which the client operates, including its organization and operating characteristics, sufficient to identify areas of high or unusual risk associated with the engagement and to evaluate the reasonableness of industry-specific estimates.
• The professional standards applicable to the engagement being performed and to the industry in which the client operates. Such standards include accounting, auditing, and attestation standards, as well as rules and regulations issued by applicable regulators.
• The skills that contribute to sound professional judgment, including the ability to exercise professional skepticism.
• How the organization uses information technology and the manner in which information systems are used to record and maintain financial information.

2.29 Policy 3: The firm determines the capabilities and competencies possessed by personnel. Multioffice CPA Firm implements this policy through the following procedures:

• Establishing criteria for evaluating personal characteristics such as integrity, competence, and motivation
• Evaluating personnel at least annually to determine their capabilities and competencies

2.30 Policy 4: The firm assigns responsibility for each engagement to an engagement partner. Multioffice CPA Firm implements this policy through the following procedures:

• Assigning the responsibility for each engagement to an engagement partner who has the appropriate capabilities, competence, authority, and time to perform the role
• Clearly defining and communicating the responsibilities of the partner to the engagement partner
• Communicating the identity and role of the partner to management and those charged with governance
• Developing and maintaining systems to monitor the workload and availability of engagement partners to enable these individuals to have sufficient time to adequately discharge their responsibilities

2.31 Policy 5: The firm assigns personnel (including partners) based on the knowledge, skills, and abilities required in the circumstances and the nature and extent of supervision needed. Multioffice CPA Firm implements this policy through the following procedures:
• Designating an appropriate person(s) in each office to be responsible for assigning personnel to engagements based on such factors as the following:
  — Engagement type, size, significance, complexity, and risk profile
  — Specialized experience or expertise required and competencies gained through previous experience or education
  — Need for and availability of staff and supervisors
  — Timing of the work to be performed
  — Continuity and rotation of personnel
  — Opportunities for on-the-job training
  — Situations for which independence or objectivity concerns exist

• Designating a partner to be responsible for partner and manager assignments

• Requiring approval of partner and manager assignments from the industry partner or the quality assurance partner in the case of high-risk or significant client engagements

• Establishing a policy for monitoring the continuation and rotation of engagement partners

2.32 Policy 6: Personnel participate in general and industry-specific continuing professional education (CPE) and professional development activities that enable them to accomplish assigned responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA societies, state boards of accountancy, and other applicable regulators. Multioffice CPA Firm implements this policy through the following procedures:

• Designating a partner to oversee the development of firm requirements and materials for a professional development program covering subjects relevant to the firm’s clients and services. Such responsibilities include the following:
  — Encouraging personnel to pass the Uniform CPA Examination
  — Establishing guidelines for participation by personnel in professional development programs and considering the requirements of the AICPA, state boards of accountancy, and applicable regulators in establishing the firm’s CPE requirements
  — Maintaining appropriate documentation evidencing that personnel have met the professional education requirements of the firm, the AICPA, state boards of accountancy, and other applicable regulators
  — Providing an orientation program and training for new personnel to inform them of their professional responsibilities and firm policies
  — Preparing and providing publications and programs to inform personnel of their responsibilities and opportunities
  — Developing in-house staff training programs that focus on general and industry-specific accounting and auditing subjects, including audits of financial institutions

• Communicating and distributing to personnel changes in accounting, auditing, attestation, and quality control standards, as well as independence, integrity, and objectivity requirements and the firm’s guidance with respect to those standards and requirements

• Encouraging professional personnel at each level in the firm to participate in external professional development activities such as the following:
  — CPE courses
  — Meetings of professional organizations
  — Serving on professional committees
  — Writing for professional publications
2.33 Policy 7: Personnel selected for advancement have the qualifications necessary to fulfill the responsibilities they will be called on to assume. Multioffice CPA Firm implements this policy through the following procedures:

- Appointing a director of human resources to identify and communicate, in the firm’s policies and procedures manual, the qualifications necessary to accomplish responsibilities at each professional level in the firm. This includes the following:
  - Establishing criteria for evaluating personnel at each professional level and for advancement to the next higher level of responsibility. Such criteria give recognition and reward to the development and maintenance of competence and commitment to ethical principles.
  - Developing evaluation forms for each professional staff classification, including partners. Such forms include evaluation of performance quality and adherence to ethical principals.
  - Informing personnel that failure to adhere to the firm’s policies and procedures regarding performance quality and commitment to ethical principles may result in disciplinary action.

- Assigning responsibility to a partner for making advancement and termination decisions for staff and recommendations to the firm’s management committee for manager and partner-level advancement and termination. Such responsibilities include the following:
  - Identifying responsibilities and requirements for evaluation at each level and indicating who will prepare these evaluations and when they will be prepared.
  - Reviewing evaluations on a timely basis with the individual being evaluated.

- Advising personnel regarding their progress and career opportunities through the following procedures:
  - Evaluating employees annually and at the end of each assignment exceeding three weeks to provide feedback on performance.
  - Summarizing and reviewing with personnel their performance evaluations, including assessing their progress with the firm, at least annually. Considerations include past performance, future objectives of the firm and the individual, assignment preferences, and career opportunities.
  - Evaluating partners periodically by means of performance reviews, peer evaluations, or self-appraisals, as appropriate, to provide feedback and to determine whether they continue to have the qualifications to accomplish their assigned responsibilities and to assume additional responsibilities.

Engagement Performance

2.34 The objective of the engagement performance element of quality control is to provide the firm with reasonable assurance (a) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements and (b) that the firm or the engagement partner issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed. Multioffice CPA Firm satisfies these objectives by establishing and maintaining the policies and procedures described in paragraphs 2.35–.45.
Policy 1: Planning for engagements meets professional, regulatory, and the firm’s requirements. Multioffice CPA Firm implements this policy by developing, maintaining, and providing personnel with the firm’s policies and procedures manual that delineates the factors the engagement team should consider in the planning process and the extent of documentation of these considerations. Planning considerations may vary depending on the size and complexity of the engagement. Planning generally includes the following activities:

- Assigning responsibility to the engagement partner for planning the engagement and assigning responsibilities to appropriate personnel during the planning phase
- Developing or updating background information about the client
- Considering client significance to the firm
- Requiring, for all initial audit clients designated as high risk by the firm, an independent review of planning considerations by either the engagement quality control reviewer or another partner
- Requiring planning documentation that includes the following:
  - Proposed work programs tailored to the specific engagement
  - Staffing requirements, including the need for personnel with specialized knowledge who may have to be obtained from other practice offices
  - Consideration of the economic conditions affecting the client and its industry and their potential effect on the conduct of the engagement
  - Consideration of risks and how they may affect the procedures to be performed
  - A budget that allocates sufficient time for the engagement to be performed in accordance with professional standards and the firm’s quality control policies and procedures
  - Evidence of review of planning by an independent review partner

Policy 2: The engagement is performed, supervised, reviewed, documented, and reported (or communicated) in accordance with the requirements of professional standards, applicable regulators, and the firm. Multioffice CPA Firm implements this policy by requiring personnel to comply with the firm’s policies and procedures manual, which prescribes the following:

- How engagement teams are supervised during the course of an engagement, including briefing the engagement team on the objectives of their work
- The form and content of documentation of the work performed and conclusions reached, including forms, checklists, and questionnaires to be used in performing engagements
- The form in which instructions are to be given to other offices or other auditors performing part of an engagement and the extent to which such work is to be reviewed and documented
- The extent of overall engagement review required, at all professional levels, to ensure that the financial statements meet professional and firm presentation and disclosure requirements
- The extent of review to be performed of required communications to management and the board of directors

Policy 3: Qualified engagement team members review work performed by other team members on a timely basis. Multioffice CPA Firm implements this policy through the following procedures:

- Adhering to the following firm guidelines regarding review of documentation of the work performed and conclusions reached, the financial statements, and reports and documentation of the review process:
  - All reviewers are to possess appropriate experience, competence, authority, and responsibility and are to be given access to the firm’s reference material and other resources.
— For each engagement, there is to be appropriate documentation evidencing review of the
documentation of the work performed and conclusions reached, the financial statements,
and the report.

• Assigning responsibility for the review of all reports, financial statements, and documentation of
the work performed and conclusions reached to an appropriate reviewer in accordance with
procedures outlined in the firm’s manual to obtain reasonable assurance of the following:

— The nature, timing, and extent of procedures performed are consistent with risk assess-
ments and the approach described in the planning documentation. Exceptions are
appropriately investigated. The appropriateness of planned procedures should be recons-
sidered if significant changes in risk factors occur or are identified between the planning
phase of the engagement and the execution of procedures.

— Firm-prescribed forms, checklists, and questionnaires, tailored as appropriate, are used in
performing and reporting on the engagement.

• Requiring a second review, by a partner or manager, of the report, financial statements, and selected
documentation of the work performed and conclusions reached, as prescribed in the firm’s policies
and procedures manual. The extent of review varies based on the type of engagement. For example,
engagements for financial institutions, high-risk engagements, and those performed for significant
clients, as defined by the firm, receive an engagement quality control review.

• Reviewing engagement documentation to determine whether the following has occurred:

— The work has been performed in accordance with professional standards and regulatory
and legal requirements.

— Significant findings and issues have been raised for further consideration.

— Appropriate consultations have taken place, and the resulting conclusions have been
documented and implemented.

— The nature, timing, and extent of work performed are appropriate and do not need
revision.

— The work performed supports the conclusions reached and is appropriately documented.

— The evidence obtained is sufficient and appropriate to support the report.

— The objectives of the engagement procedures have been achieved.

2.38 Policy 4: Engagement teams complete the assembly of final engagement files on a timely basis. Multioffice
CPA Firm implements this policy by completing the assembly of final engagement files in accordance with
professional standards and applicable regulatory requirements, if any.

2.39 Policy 5: The firm maintains the confidentiality, safe custody, integrity, accessibility, and retrievability of
engagement documentation. Multioffice CPA Firm implements this policy through the following procedures:

• Establishing and applying controls to accomplish the following:

— Clearly determine when and by whom engagement documentation was prepared and
reviewed.

— Protect the integrity of the information at all stages of the engagement, especially when
the information is shared within the engagement team or transmitted to other parties via
electronic means.

— Prevent unauthorized changes to the engagement documentation.

— Allow access to the engagement documentation by the engagement team and other
authorized parties as necessary to properly discharge their responsibilities.
• Requiring the use of a password by engagement team members and data encryption to restrict access to electronic engagement documentation to authorized users

• Implementing appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement

• Implementing procedures for properly distributing engagement documentation materials to the team members at the start of the engagement, preparing engagement documentation during the engagement, and assembling final documentation at the end of the engagement

• Implementing procedures for restricting access to, and enabling proper distribution and confidential storage of, hardcopy engagement documentation

• Implementing procedures regarding original paper documents that have been electronically scanned or otherwise copied to another media that accomplish the following:
  — Generate scanned copies that contain the entire content of the original paper documentation, including manual signatures, cross-references, and annotations.
  — Integrate the scanned copies into the engagement files, including indexing and signing off on the copies as necessary.
  — Enable the scanned copies to be retrieved and printed as necessary.

2.40 Policy 6: The firm retains engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations. Multioffice CPA Firm implements this policy through the following procedures:

• Establishing procedures that accomplish the following:
  — Enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation because the underlying technology may be upgraded or changed over time.
  — Provide, where necessary, a record of changes made to engagement documentation after the assembly of engagement files has been completed.
  — Enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.

• Retaining documentation for a specific period of time as appropriate for the nature of the engagement

2.41 Policy 7: The firm requires that consultation take place when appropriate; that sufficient and appropriate resources are available to enable appropriate consultation to take place; that all the relevant facts known to the engagement team are provided to those consulted; that the nature, scope, and conclusions of such consultations are documented; and that conclusions resulting from such consultations are implemented. Multioffice CPA Firm implements this policy through the following procedures:

• Providing personnel with the firm’s policies and procedures manual that specifies the firm’s consultation policies and procedures. Areas or specialized situations for which the firm requires consultation include the following:
  — Application of newly issued technical pronouncements.
  — Industries with special accounting, auditing, or reporting requirements.
  — Emerging practice problems.
  — Choices among alternative GAAP upon initial adoption or when an accounting change is made.
  — Reissuance of a report, consideration of omitted procedures after a report has been issued, or subsequent discovery of facts that existed at the date a report was issued.
— Filing requirements of regulators.
— Meetings with regulators at which the firm is to be called upon to support the application of GAAP or GAAS that have been questioned.
— Designating individuals within the firm as consultants in certain areas. Personnel are to consult with the designated individual when issues arise. If differences arise between the engagement partner and the consultant, the matter is to be resolved by the partner(s) responsible for the quality control function.

- Maintaining or providing access to adequate and up-to-date references, which includes materials related to specific industries, specialties, and regulatory requirements, in each office.
- Requiring that documentation of consultation include all relevant facts and circumstances, the sections of the professional literature used in making a determination, the conclusion reached, how the conclusions were implemented, and the signatures of the engagement partner and consultant. This documentation is to be retained with the engagement documentation of the work performed and conclusions reached. At the discretion of the consultant, the documentation may be entered in a retrievable database to promote efficiencies in the consultation process and consistency in the resolution of similar issues.

2.42 Policy 8: The firm deals with and resolves differences of opinion, documents and implements conclusions reached, and does not release the report until the matter is resolved. Multioffice CPA Firm implements this policy through the following procedures:

- Requiring that all differences of professional judgment within an engagement team be resolved by the engagement and quality control partners, and the managing partner if necessary, and that the report not be released until the matter is resolved.
- Requiring that the resolution of the differences be appropriately documented. If members of the engagement team continue to disagree with the resolution, they may disassociate themselves from the resolution of the matter and may document that a disagreement continues to exist.

2.43 Policy 9: The firm has criteria for determining whether an engagement quality control review should be performed; evaluates all engagements against the criteria; performs an engagement quality control review for all engagements that meet the criteria; and completes the review before the report is released. Multioffice CPA Firm implements this policy by defining high-risk engagements and requiring that an engagement quality control review be performed for all high-risk engagements, engagements for financial institutions, and engagements performed for significant clients.

2.44 Policy 10: The firm establishes procedures addressing the nature, timing, extent, and documentation of the engagement quality control review. Multioffice CPA Firm implements this policy through the following procedures:

- Implementing procedures addressing the timing of the review. The firm has concluded that performing an engagement quality control review is not necessary to obtain sufficient appropriate audit evidence for audit engagements; therefore, the engagement quality control review does not need to be completed before the date of the auditor’s report but is required to be completed before the report is released. When the engagement quality control review results in additional audit procedures being performed, the date of the auditor’s report is changed to the date by which sufficient appropriate audit evidence has been obtained.
- Implementing procedures addressing the nature and extent of the review. The firm’s procedures for audit and attestation engagements require that the engagement quality control reviewer do the following:
  — Discuss significant accounting, auditing, and financial reporting issues with the engagement partner, including matters for which there has been consultation.
— Discuss with the engagement partner the engagement team’s identification and audit of high-risk assertions, transactions, and account balances.

— Review selected working papers relating to the significant judgments the engagement team made and the conclusions they reached.

— Review documentation of the resolution of significant accounting, auditing, and financial reporting issues, including documentation of consultation with firm personnel or external sources.

— Review the summary of uncorrected misstatements that are related to known and likely misstatements.

— Review additional engagement documentation to the extent considered necessary.

— Read the financial statements and report and consider whether the report is appropriate.

— Confirm with the engagement partner that there are no significant unresolved issues.

— Complete the review before the release of the report.

— Determine whether the issues raised in the review indicate a need to change the auditor’s report date.

• Resolving conflicting opinions between the engagement partner and the engagement quality control reviewer regarding significant matters. The policy requires documentation of the resolution of conflicting opinions before the release of the audit report.

• Implementing procedures addressing documentation by the engagement quality control reviewer. The firm’s procedures require documentation of the following:

  — That the procedures required by the firm’s policies on engagement quality control review have been performed

  — That the engagement quality control review has been completed before the report is released

  — That no matters have come to the attention of the engagement quality control reviewer that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate

2.45 Policy 11: The firm establishes criteria for the eligibility of engagement quality control reviewers. Multioffice CPA Firm implements this policy by establishing the following criteria for an engagement quality control reviewer:

• Is not selected by the engagement partner

• Has sufficient technical expertise and experience

• Carries out his or her responsibilities with objectivity and due professional care without regard to the relative positions of the engagement partner and the engagement quality control reviewer

• Does not assume any of the responsibilities of the engagement partner or have responsibility for the audit of any significant subsidiaries, divisions, benefit plans, or affiliated or related entities

• Meets the independence requirements relating to the engagements reviewed, even though the engagement quality control reviewer is not a member of the engagement team

• Does not make decisions for the engagement team or participate in the performance of the engagement, except that the engagement partner may consult the engagement quality control reviewer at any stage during the engagement
Monitoring

2.46 The objective of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm’s quality control system, and a firm’s compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

• Adherence to professional standards and regulatory and legal requirements
• Whether the quality control system has been appropriately designed and effectively implemented
• Whether the firm’s quality control policies and procedures have been operating effectively so that reports that are issued by the firm are appropriate in the circumstances

2.47 Multioffice CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 2.48–51.

2.48 Policy 1: The firm assigns responsibility for the monitoring process to a partner and assigns performance of the monitoring process to competent individuals. Multioffice CPA Firm implements this policy through the following procedures:

• Designating a partner with appropriate authority to be responsible for quality assurance, including ensuring that the firm’s quality control policies and procedures and its methodologies remain relevant and adequate. Factors to be considered include the following:
  — Mergers and divestitures of portions of the practice
  — Changes in professional standards and other regulatory requirements applicable to the firm’s practice
  — Results of inspections and peer reviews
  — Reviews of litigation and regulatory enforcement actions against the firm and others
  — Changes in applicable AICPA membership requirements
• Preparing inspection checklists and guidance materials or using materials prepared by the AICPA for performing inspection procedures.
• Determining whether personnel have been appropriately informed of their responsibilities for maintaining the firm’s standards of quality in performing their duties.
• Identifying the need to take the following actions:
  — Revise policies and procedures related to the other elements of quality control because they are ineffective or inappropriately designed
  — Improve compliance with firm policies and procedures related to the other elements of quality control
• Assigning performance of the monitoring process to the designated quality control individual for each practice office.

2.49 Policy 2: The firm performs monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm’s quality control policies and procedures. Multioffice CPA Firm implements this policy through the following procedures:

• Developing and performing the firm’s inspection program to obtain feedback about the effectiveness of the firm’s policies and procedures.
• Reviewing the resolution of matters reported by professional personnel on independence-confirmation forms to determine that matters have been appropriately considered and resolved.

• Interviewing personnel at all professional management and staff levels to obtain information about operating procedures in practice offices, whether personnel are knowledgeable about firm policies and procedures, and whether such policies and procedures are being effectively communicated.

• Reviewing the following documentation to determine compliance with firm policies and procedures:
  — Personnel evaluations, including documentation of hiring and advancement decisions
  — Documentation of client acceptance and continuance decisions
  — Participants’ evaluations of practice office training programs
  — Professional development records of personnel
  — Correspondence regarding the resolution of independence matters within the practice office

• Developing a plan to test a sample of engagements for compliance with the firm’s policies and procedures. Such a review may be preissuance or postissuance.

• Reviewing a cross-section of engagements from selected practice offices using the following criteria for inclusion in the sample selected:
  — Engagements involving all partners and managers who have significant accounting and auditing responsibilities in the selected offices
  — Engagements for financial institutions
  — First-year engagements
  — Significant client engagements
  — Specialized industries, with emphasis given to high-risk industries
  — Level of service performed (audit, review, compilation, and attestation)
  — Level of attestation services performed (examination, review, and agreed-upon procedures)
  — Engagements for which there have been complaints or allegations that the work performed by the firm fails to comply with professional standards, regulatory requirements, or the firm’s system of quality control
  — Engagements in which there were significant disagreements between the quality review partner and the engagement partner

• Periodically reviewing the process for personnel evaluation and counseling to ascertain the following:
  — Procedures for evaluation and documentation are being followed on a timely basis
  — Personnel who have been promoted have achieved the applicable requirements for advancement
  — Personnel decisions are consistent with evaluations
  — Recognition is given to outstanding performance

• Designating a partner or qualified individual in each office to review the summary of the evaluations of in-house training programs to determine whether the programs are achieving their objectives.
Designating a partner or qualified individual in each office to review summaries of CPE records for that office’s professional staff to determine that the office has established a means of tracking each individual’s compliance with the requirements of the AICPA and other applicable regulators.

• Interviewing selected professional personnel regarding the effectiveness of training programs.
• Considering the results of the firm’s inspection as they relate to the effectiveness of the firm’s professional development program.
• Ascertaining whether inquiries received by individuals consulted within the firm indicate the need for additional CPE programs.
• Reviewing and updating firm practice aids, such as audit programs, forms, and checklists, to reflect new or revised professional pronouncements.
• Issuing guidance regarding new professional standards, regulatory requirements, and related changes to firm policy.
• Soliciting comments from partners and managers as to the effectiveness of practice aids and tools.

Policy 3: The firm communicates at least annually (a) deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action to relevant engagement partners and other appropriate personnel and (b) the results of the monitoring of its quality control system process to relevant firm personnel. Multioffice CPA Firm implements this policy through the following procedures:

• Preparing a summary monitoring report for the firm’s senior management that evaluates the overall results of the inspection and other monitoring procedures and reaches final conclusions as to whether the firm as a whole needs to improve compliance with the firm’s policies and procedures and whether revisions to the firm’s quality control policies and procedures are necessary.
• Communicating findings to practice office personnel and determining the corrective actions to be taken for the engagements reviewed. These findings are discussed and communicated in a report issued to each office. The practice office responds regarding the specific corrective actions or steps to be taken to improve compliance with the firm’s policies and procedures and professional standards.
• Following up on planned corrective actions to determine whether those actions were taken and whether they achieved the intended objective(s).
• Communicating in partner-manager meetings and firm policy correspondence the need for changes in the system of quality control.
• Communicating in training programs, partner-manager meetings, and firm policy correspondence the need for improved compliance with the system of quality control.

Policy 4: The firm deals appropriately with complaints and allegations. Multioffice CPA Firm implements this policy through the following procedures:

• Establishing procedures for concerns to be brought to the attention of the ethics committee in a confidential manner
• Having the firm’s ethics committee (excluding any members who are otherwise involved in the engagement under investigation) investigate the following:
  — Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements
  — Allegations of noncompliance with the firm’s system of quality control
  — Deficiencies in the design or operation of the firm’s quality control policies and procedures, or noncompliance with the firm’s system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations
• Consulting with legal counsel as necessary
• Documenting complaints and allegations and the responses to them

2.52 Policy 5: The firm prepares appropriate documentation to provide evidence of the operation of each element of its system of quality control. Multioffice CPA Firm implements this policy by designing its summary monitoring report to provide evidence of the operation of each element of its system of quality control, including the following:

• Monitoring procedures, including the procedure for selecting completed engagements to be inspected

• A record of the evaluation of the following:
  — Adherence to professional standards and regulatory and legal requirements
  — Whether the quality control system has been appropriately designed and effectively implemented
  — Whether the firm’s quality control policies and procedures have been appropriately applied

• Identification of the deficiencies noted, an evaluation of their effects, and the basis for determining whether further action is necessary and what that action should be

2.53 Policy 6: The firm retains documentation providing evidence of the operation of the system of quality control for an appropriate period of time. Multioffice CPA Firm implements this policy by requiring retention of the summary monitoring report for a period of time sufficient to meet the firm’s peer review or other regulatory requirements.
Chapter 3:

System of Quality Control for a CPA Firm’s Accounting and Auditing Practice—Firm With a Single Office

3.01 This chapter describes how a CPA firm that has a single office (Single office CPA Firm) implements each element of quality control in its accounting and auditing practice. Single office CPA Firm is a hypothetical firm with 1 office, 3 partners, and a total of 10 professionals. Its accounting and auditing practice has a concentration of employee benefit plans, and the firm has no issuer clients. The firm uses practice aids that have been subjected to peer review in accordance with standards established by the AICPA. These practice aids are supplemented by oral and written communications from the firm’s partners.

Quality Control Policies and Procedures

3.02 The firm’s system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those policies. The policies and procedures are required to be documented. Single office CPA Firm documents its system of quality control by preparing a document that comprehensively describes the policies and procedures for each element of quality control. Single office CPA Firm reviews the documentation at least annually and updates it as necessary.

3.03 The firm should communicate its quality control policies and procedures to its personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve
- The message that each individual has a personal responsibility for quality

3.04 Single office CPA Firm communicates these policies and procedures in writing and makes the documentation available electronically to all professional personnel. Single office CPA Firm requires each individual to be familiar with and to comply with these policies and procedures. Single office CPA Firm encourages its personnel to communicate their views or concerns about quality control matters to partners.

Leadership Responsibilities for Quality Within the Firm (the “Tone at the Top”)

3.05 The objective of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. Single office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 3.06–10.

3.06 Policy 1: The firm’s managing partner assumes ultimate responsibility for the firm’s system of quality control. Single office CPA Firm implements this policy through the following procedures:

- Having the managing partner accept ultimate responsibility for the firm’s system of quality control and for setting a tone that emphasizes the importance of quality and of following the firm’s system of quality control
- Informing personnel that failure to adhere to the firm’s policies and procedures regarding performance quality and commitment to ethical principles may result in disciplinary action

3.07 Policy 2: Commercial considerations do not override the quality of the work performed. Single office CPA Firm implements this policy through the following procedures:

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1 If Single office CPA Firm were to be engaged to perform audit services for an issuer, it might need to revise its quality control policies and procedures to comply with Public Company Accounting Oversight Board (PCAOB) standards and to reflect Securities and Exchange Commission (SEC) requirements applicable to audits of issuers.
• Having the managing partner continually evaluate client relationships and specific engagements so that commercial considerations do not override the objectives of the system of quality control

• Emphasizing to all personnel that fee considerations and scope of services should not infringe upon quality work

3.08 Policy 3: Responsibility for developing, implementing, and operating the firm’s quality control system is assigned to personnel with sufficient and appropriate experience, authority, and ability. Single office CPA Firm implements this policy by having the managing partner designate a quality control partner who is responsible for designing, implementing, and monitoring the firm’s quality control system.

3.09 Policy 4: Performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel demonstrate the firm’s overarching commitment to the objectives of the system of quality control. Single office CPA Firm implements this policy through the following procedures:

• Designing and implementing performance evaluation and advancement systems that reward partners and staff involved in the accounting and auditing practice for the quality of their work and their compliance with professional standards.

• Establishing a compensation system that provides incentives to accounting and auditing partners and senior-level employees for the quality of their accounting and auditing work. The compensation system does the following:
  — Takes into consideration firm feedback based on monitoring results and peer reviews of the work performed
  — Rewards partners and personnel for timely (a) identification of significant and emerging accounting and auditing issues and (b) consultation with firm experts

3.10 Policy 5: The firm devotes sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures. Single office CPA Firm implements this policy through the following procedures:

• Providing the designated quality control partner with sufficient time, authority, and resources to develop, implement, and maintain the firm’s quality control policies and procedures

• Providing the firm’s quality control documentation to personnel when they are initially hired and reviewing the documentation with them

• Reviewing the firm’s quality control policies and procedures with personnel at firm training sessions at least annually

Relevant Ethical Requirements

3.11 The objective of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Single office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 3.12–17.

3.12 Policy 1: Personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the GAO, and any other applicable regulators. Single office CPA Firm implements this policy through the following procedures:

• Designating a quality assurance partner to review relevant pronouncements relating to independence, integrity, and objectivity; answer questions; determine the circumstances for which consultation with sources outside the firm is required; and resolve matters

• Providing personnel with access to the AICPA Professional Standards service
• Establishing a system for identifying all services performed for each client and evaluating whether any of those services might impair independence

3.13 Policy 2: The firm establishes procedures to communicate independence requirements to firm personnel and, where applicable, others subject to them. Single office CPA Firm implements this policy through the following procedures:

• Informing personnel of those entities to which independence policies apply by doing the following on a timely basis:
  — Preparing and maintaining a list of entities with which firm personnel are prohibited from having a financial or business relationship
  — Making the list available to personnel so they may evaluate their independence (including personnel new to the firm)
  — Notifying personnel of changes in the list

• Providing frequent reminders of professional responsibilities to personnel, such as avoiding behavior that might be perceived as impairing their independence or objectivity

3.14 Policy 3: The firm establishes procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards. Single office CPA Firm implements this policy through the following procedures:

• Requiring the engagement partner to consider relevant information about client engagements, including the scope of services, to enable him or her to evaluate the overall impact, if any, on independence requirements

• Accumulating and communicating relevant information to appropriate personnel so that the following can occur:
  — The firm, the engagement partner, and other firm personnel can readily determine whether they satisfy independence requirements.
  — The firm can maintain and update information relating to independence.
  — The firm and the engagement partner can take appropriate action regarding identified threats to independence.

• Requiring personnel to promptly report circumstances and relationships that create a threat to independence, and independence breaches of which they become aware, so that appropriate action can be taken

• Establishing criteria to determine the need for safeguards for engagements where the following have taken place:
  — Monitoring procedures or peer review has identified weaknesses in previous years.
  — The same senior personnel have been used for five years or more on an audit or attestation engagement.

• Promptly communicating identified breaches of these policies and procedures, and the required corrective actions, to the following personnel:
  — The engagement partner who, with the firm, needs to address the breach
  — Other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action

• Requiring the engagement partner and the other individuals referred to in the previous list to confirm to the firm that the required corrective actions have been taken
• Having a partner, or an individual designated by the partner, periodically review unpaid fees from clients to ascertain whether any outstanding amounts impair the firm’s independence

• Establishing additional procedures that provide safeguards when the firm performs audit or other attest work for (a) significant clients or (b) clients at which partners or other senior personnel are offered key management positions or have accepted offers of employment

3.15 Policy 4: The firm withdraws from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied. Single office CPA Firm implements this policy through the following procedures:

• Consulting within the firm, and with legal counsel and other parties if necessary, when the firm believes that effective safeguards to reduce threats to independence to an acceptable level cannot be applied

• Withdrawing from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied

3.16 Policy 5: The firm obtains written confirmation, at least annually, of compliance with its policies and procedures on independence from all firm personnel required to be independent by relevant requirements. Single office CPA Firm implements this policy through the following procedures:

• Obtaining written representations from personnel, upon hire and on an annual basis, stating that they have read the firm’s independence, integrity, and objectivity policies, understand the applicability of those policies to their activities, and have complied with the requirements of those policies since their last representation. (Such written representations are accompanied by the most current list of all entities with which firm personnel are prohibited from having a business relationship.)

• Reviewing these independence representations for completeness and resolving reported exceptions.

• Requiring the engagement partner to sign a step in the engagement program attesting to compliance with independence requirements that apply to the engagement.

3.17 Policy 6: The firm establishes procedures for confirming the independence of another firm that performs part of the engagement. Single office CPA Firm implements this policy through the following procedures:

• Using practice aids that prescribe the form and content of independence representations, and frequency with which they are to be obtained

• Requiring that such representations be documented

Acceptance and Continuance of Client Relationships and Specific Engagements

3.18 The objective of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm’s client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client’s management could reflect the reliability of the client’s accounting records and financial representations and, therefore, affect the firm’s reputation or involvement in litigation. A firm’s policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

• has considered the integrity of the client, including the identity and business reputation of the client’s principal owners, key management, related parties, and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;
is competent to perform the engagement and has the capabilities and resources to do so;
• can comply with legal and ethical requirements; and
• has reached an understanding with the client regarding the services to be performed.

3.19 Single office CPA Firm satisfies this objective, both with respect to the initial period for which the firm is performing its service and for subsequent periods, by establishing and maintaining the policies and procedures described in paragraphs 3.20–24.

3.20 Policy 1: The firm evaluates factors that have a bearing on management’s integrity and considers the risk associated with providing professional services in particular circumstances. Single office CPA Firm implements this policy through the following procedures:
• Informing personnel of the firm’s policies and procedures for accepting and continuing clients, including those outlined in the firm’s practice aids.
• Obtaining and evaluating relevant information such as the following before accepting or continuing a client:
  — The nature and purpose of the services to be provided and management’s understanding thereof
  — The identity of the client’s principal owners, key management, related parties, and those charged with its governance
  — Information obtained from inquiries of the client’s bankers, factors, attorneys, credit services, and others who have business relationships with the entity
  — The nature of the client’s operations, including its business practices, from sources such as annual reports, interim financial statements, reports to and from regulators, income tax returns, and credit reports
  — Information concerning the attitude of the client’s principal owners, key management, and those charged with its governance toward such matters as aggressive interpretation of accounting standards and internal control over financial reporting
• Evaluating the risk of providing services for the following engagements:
  — Engagements for entities operating in highly specialized or regulated industries, including financial institutions, governmental entities, and employee benefit plans
  — Engagements that require an inordinate amount of time to complete relative to the available resources of the firm
• Communicating with the predecessor accountant or auditor when required or recommended by professional standards. This communication also includes inquiries regarding the nature of any disagreements and whether there is evidence of opinion-shopping.
• Conducting a background check of the business, its officers, and the person(s) in question by using the services of an investigative company and evaluating the information obtained regarding management’s integrity. Background checks are conducted when the firm is unable to obtain sufficient information about the prospective client after taking the steps described previously, or there is an indication that management or someone affiliated with the prospective client may be less than reputable.
• Evaluating the risk of providing services to significant clients or to other clients for which the firm’s objectivity or the appearance of independence may be impaired. In broad terms, the significance of a client to a firm refers to relationships that could diminish a practitioner’s objectivity and independence in performing attest services. In determining the significance of a client, the firm considers (a) the amount of time the partner devotes to the engagement, (b) the effect on the partner’s stature within the firm as a result of his or her service to the client, (c) the manner in which
the partner is compensated, and (d) the effect that losing the client would have on the partner and the firm.

3.21 **Policy 2:** The firm evaluates whether the engagement can be completed with professional competence; undertakes only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluates, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued. Single office CPA Firm implements this policy through the following procedures:

- Evaluating whether the firm has obtained or can reasonably expect to obtain the knowledge and expertise necessary to perform the engagement, including relevant regulatory or reporting requirements.
- Evaluating whether the following are in place:
  - The firm has sufficient personnel with the necessary capabilities and competence.
  - Specialists are available if needed.
  - Individuals meeting the criteria and eligibility requirements to perform an engagement quality control review are available, when needed.
  - The firm is able to complete the engagement within the reporting deadline.
- Specifying conditions that trigger the requirement to reevaluate a specific client or engagement. The following are examples of such conditions:
  - Significant changes in the client, such as a major change in senior client personnel, ownership, advisers, the nature of its business, or the financial stability of the client.
  - Changes in the nature or scope of the engagement, including requests for additional services.
  - Changes in the composition of the firm, such as the loss of and inability to replace key personnel who are particularly knowledgeable about a specialized industry.
  - The decision to discontinue services to clients in a particular industry.
  - The existence of conditions that would have caused the firm to reject the client or engagement had such conditions existed at the time of the initial acceptance.
  - The client’s delinquency in paying fees. (This may also affect the firm’s independence.)
  - Engagements for entities operating in highly specialized or regulated industries, such as financial institutions, governmental entities, and employee benefit plans.
  - Engagements for entities in which there may be substantial doubt about the entity’s ability to continue as a going concern.
  - Engagements in which the client has ignored prior recommendations, such as those that address deficiencies in internal control.
- Obtaining relevant information to determine whether the relationship should be continued and establishing a frequency for evaluations (for example, continuance decisions are made at least annually).
- Evaluating the information obtained regarding acceptance or continuance of the client or engagement through the following activities:
  - The engagement partner assesses the information obtained about the client or the specific engagement, including information about the significance of the client to the firm, and makes a recommendation about whether the client or engagement should be accepted or continued.
  - The engagement partner completes a client acceptance form and submits it to the managing partner for approval.
c. The engagement partner signs a step in the planning program noting consideration of client continuance and completes a form documenting the rationale and conclusion regarding client continuance if conditions exist that trigger the requirement to reevaluate a client or engagement between annual audits.

d. The managing partner assesses and approves the recommendation made by the engagement partner. If the managing partner recommends not accepting a client or discontinuing a client relationship, the managing partner discusses his or her reasons for the acceptance or continuance decision with the other partners.

- Establishing procedures for dealing with information that would have caused the firm to decline the engagement if the information had been available earlier.

3.22 Policy 3: The firm obtains an understanding with the client regarding the services to be performed. Single office CPA Firm implements this policy by requiring that, for all engagements, the firm prepare a written engagement letter documenting the understanding with the client and obtain the client’s signature on that letter, thus minimizing the risk of misunderstanding regarding the nature, scope, and limitations of the services to be performed.

3.23 Policy 4: The firm establishes procedures on withdrawal from an engagement or from both the engagement and the client relationship. Single office CPA Firm implements this policy through the following procedures:

- Discussing with the appropriate level of the client’s management and those charged with its governance the appropriate action that the firm might take based on the relevant facts and circumstances
- Considering whether there is a professional, regulatory, or legal requirement for the firm to remain in place or for the firm to report to regulatory authorities the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal
- Discussing with the appropriate level of the client’s management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship if the firm determines that it is appropriate to withdraw

3.24 Policy 5: The firm documents how issues relating to acceptance or continuance of client relationships and specific engagements were resolved. Single office CPA Firm implements this policy by documenting, in a memorandum to the engagement files, significant issues, consultations, conclusions, and the basis for the conclusions relating to acceptance or continuance of client relationships and specific engagements.

Human Resources

3.25 The objective of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (a) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (b) to enable the firm to issue reports that are appropriate in the circumstances. Single office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 3.26–3.22.

3.26 Policy 1: Personnel who are hired possess the characteristics that enable them to perform competently. Single office CPA Firm implements this policy through the following procedures:

- Designating an individual in the firm to be responsible for the following activities:
  — Managing the human resources function
  — Evaluating the firm’s personnel needs by considering factors such as existing clientele, anticipated growth, personnel turnover, and individual advancement
  — Developing criteria for determining which individuals will be involved in the interviewing and hiring process
Establishing an understanding among the partners about the attributes, achievements, and experiences desired in entry-level and experienced personnel

Setting guidelines for the additional procedures to be performed when hiring experienced personnel, such as performing background checks and inquiring about any outstanding regulatory actions

3.27 Policy 2: The firm determines capabilities and competencies required for an engagement, including those required of the engagement partner. Single office CPA Firm implements this policy by specifying the competencies that the engagement partners of the firm’s accounting, auditing, and attestation engagements (or other persons responsible for supervising and signing or authorizing someone to sign the firm’s report on such engagements) should possess. These competencies include having an understanding of the following:

- The role of the firm’s system of quality control and the AICPA Code of Professional Conduct in ensuring the integrity of the accounting, auditing, and attest functions to users of reports.
- The performance, supervision, and reporting aspects of the engagement, which ordinarily are gained through training or participation in similar engagements.
- The industry in which the client operates, including its organization and operating characteristics, sufficient to identify areas of high or unusual risk associated with the engagement and to evaluate the reasonableness of industry-specific estimates.
- The professional standards applicable to the engagement and the industry in which the client operates. Such standards include accounting, auditing, and attestation standards, as well as rules and regulations issued by applicable regulators.
- The skills that contribute to sound professional judgment, including the ability to exercise professional skepticism.
- How the organization uses information technology and the manner in which information systems are used to record and maintain financial information.

3.28 Policy 3: The firm determines the capabilities and competencies possessed by personnel. Single office CPA Firm implements this policy through the following procedures:

- Establishing criteria for evaluating personal characteristics such as integrity, competence, and motivation
- Evaluating personnel at least annually to determine their capabilities and competencies

3.29 Policy 4: The firm assigns the responsibility for each engagement to an engagement partner. Single office CPA Firm implements this policy through the following procedures:

- Assigning responsibility for each engagement to an engagement partner who has the appropriate capabilities, competence, authority, and time to perform the role
- Clearly defining and communicating the responsibilities of the partner to the engagement partner
- Communicating the identity and role of the partner to management and those charged with governance
- Monitoring the workload and availability of engagement partners to enable these individuals to have sufficient time to adequately discharge their responsibilities

3.30 Policy 5: The firm assigns personnel (including partners) based on the knowledge, skills, and abilities required in the circumstances and the nature and extent of supervision needed. Single office CPA Firm implements this policy through the following procedures:

- Designating an appropriate person to be responsible for assigning personnel to engagements based on such factors as the following:
  - Engagement type, size, significance, complexity, and risk profile
— Specialized experience and expertise required for the engagement and competencies gained through prior experience
— Personnel availability
— Timing of the work to be performed
— Continuity and rotation of personnel
— Opportunities for on-the-job training
— Situations for which independence or objectivity concerns exist

• Designating a partner to be responsible for partner and manager assignments
• Requiring approval of partner and manager assignments from the managing partner or other partner in the case of high-risk or significant client engagements

3.31 Policy 6: Personnel participate in general and industry-specific continuing professional education (CPE) and professional development activities that enable them to accomplish assigned responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA societies, state boards of accountancy, and other regulators. Single office CPA Firm implements this policy through the following procedures:

• Encouraging personnel to pass the Uniform CPA Examination
• Assigning responsibility to a partner to maintain a professional development program that does the following:
  — Requires personnel to participate in professional development programs in accordance with firm guidelines and in subjects that are relevant to their responsibilities
  — Takes into account the requirements of the AICPA, state boards of accountancy, and other regulatory agencies in establishing the firm’s CPE requirements
  — Provides CPE course materials to, and maintains records of completed CPE for, professional personnel
  — Provides an orientation and training program for new hires
• Encouraging participation by personnel at each level in the firm in other professional development activities such as completing external professional development programs, including graduate-level and self-study courses, becoming members of professional organizations, serving on professional committees, writing for professional publications, and speaking to professional groups
• Communicating and distributing to personnel, when applicable, changes in accounting, auditing, attestation, and quality control standards, as well as independence requirements and the firm’s guidance with respect to those standards and requirements

3.32 Policy 7: Personnel selected for advancement have the qualifications to fulfill the responsibilities they will be called on to assume. Single office CPA Firm implements this policy through the following procedures:

• Assigning responsibility to the three partners to jointly make advancement and termination decisions. Such responsibilities include the following:
  — Establishing criteria for evaluating personnel at each professional level and for advancement to the next higher level of responsibility. Such criteria give recognition and reward to the development and maintenance of competence and commitment to ethical principles.
  — Informing firm personnel about the criteria for advancement to the next higher level of responsibility.
  — Designating personnel responsible for preparing evaluations and determining when they should be prepared.
Informing personnel that failure to adhere to the firm’s policies and procedures regarding performance quality and commitment to ethical principles may result in disciplinary action.

Using forms that include the applicable qualifications when evaluating the performance of personnel. Such forms include qualifications related to performance quality and adherence to ethical principles.

Reviewing evaluations on a timely basis with the individual being evaluated.

• Counseling personnel regarding their progress and career opportunities by doing the following:
  — Evaluating employees annually and at the end of each assignment lasting four weeks or longer to provide feedback on performance.
  — Summarizing and reviewing with personnel annually the evaluation of their performance, including an assessment of their progress with the firm. Considerations include past performance, future objectives of the individual and the firm, the individual’s assignment preferences, and career opportunities.
  — Evaluating partners periodically by means of counseling, peer evaluation, or self-appraisal, as appropriate.

### Engagement Performance

3.33 The objective of the engagement performance element of quality control is to provide the firm with reasonable assurance (a) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements and (b) that the firm or the engagement partner issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed. Single office CPA Firm satisfies these objectives by establishing and maintaining the policies and procedures described in paragraphs 3.34–.44.

3.34 Policy 1: Planning for engagements meets professional, regulatory, and the firm’s requirements. Single office CPA Firm implements this policy by maintaining and providing personnel with the firm’s practice aids that prescribe the factors the engagement team should consider in the planning process and the extent of documentation of those considerations. Planning considerations may vary depending on the size and complexity of the engagement. Planning generally includes the following activities:

• Assigning responsibilities to appropriate personnel during the planning phase
• Developing or updating background information on the client and the engagement
• Considering client significance to the firm
• Developing a planning document that includes the following:
  — Proposed work programs tailored to the specific engagement
  — Staffing requirements and the need for specialized knowledge
  — Consideration of the economic conditions affecting the client and its industry and their potential effect on the conduct of the engagement
  — The risks, including fraud considerations, affecting the client and the engagement and how the risks may affect the procedures performed
  — A budget that allocates sufficient time for the engagement to be performed in accordance with professional standards and the firm’s quality control policies and procedures
3.35 Policy 2: The engagement is performed, supervised, documented, and reported (or communicated) in accordance with the requirements of professional standards, applicable regulators, and the firm. Single office CPA Firm implements this policy through the following procedures:

- Providing adequate supervision during the course of an engagement, including briefing the engagement team on the objectives of their work. The training, ability, and experience of the personnel are considered when assigning supervisors to the engagement.
- Requiring that a written work program be used in all engagements.
- Addressing significant issues arising during the engagement, considering their significance, and appropriately modifying the planned approach.
- Adhering to the guidelines set forth by the firm for the form and content of documentation of the work performed and conclusions reached. Such documentation includes standardized forms, checklists, and questionnaires used in the performance of engagements and explanations, when required, of how the firm integrates such aids into engagements.
- Requiring engagement documentation in accordance with professional standards, applicable regulatory requirements, and the firm’s policies.

3.36 Policy 3: Qualified engagement team members review work performed by other team members on a timely basis. Single office CPA Firm implements this policy by adhering to the following guidelines established by the firm regarding review of the documentation of the work performed and conclusions reached, the financial statements and reports, and documentation of the review process:

- All reviewers are to have appropriate experience, competence, and responsibility.
- For each engagement, there is to be evidence of appropriate review of documentation of the work performed and conclusions reached, the financial statements, and the report.
- Engagement documentation is reviewed to determine whether the following have occurred:
  - The work has been performed in accordance with professional standards and regulatory and legal requirements.
  - Significant findings and issues have been raised for further consideration.
  - Appropriate consultations have taken place, and the resulting conclusions have been documented and implemented.
  - The nature, timing, and extent of work performed are appropriate and do not need revision.
  - The work performed supports the conclusions reached and is appropriately documented.
  - The evidence obtained is sufficient and appropriate to support the report.
  - The objectives of the engagement procedures have been achieved.

3.37 Policy 4: Engagement teams complete the assembly of final engagement files on a timely basis. Single office CPA Firm implements this policy by completing the assembly of final engagement files in accordance with professional standards and applicable regulatory requirements, if any.

3.38 Policy 5: The firm maintains the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation. Single office CPA Firm implements this policy through the following procedures:

- Establishing and applying controls to accomplish the following:
  - Clearly determine when and by whom engagement documentation was prepared and reviewed.
— Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via electronic means.

— Prevent unauthorized changes to the engagement documentation.

— Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

• Implementing procedures for properly distributing engagement documentation materials to engagement teams at the start of the engagement, preparing engagement documentation during the engagement, and assembling final documentation at the end of the engagement

• Implementing procedures to restrict access to, and enable proper distribution and confidential storage of, hardcopy engagement documentation

• Requiring the use of passwords by engagement team members and data encryption to restrict access to electronic engagement documentation to authorized users

• Implementing appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement

• Implementing procedures regarding original paper documents that have been electronically scanned or otherwise copied to another media that accomplish the following:
  — Generate copies that contain the entire content of the original paper documentation, including manual signatures, cross-references, and annotations.
  — Integrate the copies into the engagement files, including indexing and signing off on the copies as necessary.
  — Enable the copies to be retrieved and printed as necessary.

3.39 Policy 6: The firm retains engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations. Single office CPA Firm implements this policy through the following procedures:

• Retaining engagement documentation for a period of time sufficient to meet the requirements of the state board of accountancy and applicable professional standards

• Establishing procedures that
  — enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation because the underlying technology may be upgraded or changed over time;
  — provide, where necessary, a record of changes made to engagement documentation after the assembly of engagement files has been completed; and
  — enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.

3.40 Policy 7: The firm requires that consultation take place when appropriate; that sufficient and appropriate resources are available to enable appropriate consultation to take place; that all the relevant facts known to the engagement team are provided to those consulted; that the nature, scope, and conclusions of such consultations are documented; and that conclusions resulting from such consultations are implemented. Single office CPA Firm implements this policy through the following procedures:

• Consulting with those having appropriate knowledge, authority, and experience within the firm (or, where applicable, outside the firm) on significant technical, ethical, and other matters. Single office CPA firm uses advisory services provided by other firms, professional and regulatory bodies, and commercial organizations that provide relevant quality control services. Before using such services, the firm evaluates whether the external provider is qualified for that purpose.
Informing personnel of the firm’s consultation policies and procedures.

Requiring sufficiently experienced engagement team members to identify matters for consultation or consideration during the engagement.

Requiring consultation in specialized areas or situations with appropriate individuals within and outside the firm when matters such as the following arise:
   — The application of newly issued technical pronouncements
   — Industries with special accounting, auditing, or reporting requirements, including unusually complex employee benefit plans
   — Emerging practice problems
   — Choices among alternative generally accepted accounting principles upon initial adoption or when an accounting change is made
   — Reissuance of a report, consideration of omitted procedures after a report has been issued, or subsequent discovery of facts that existed at the date a report was issued
   — Filing requirements of regulators
   — Meetings with regulators at which the firm is to be called on to support the application of generally accepted accounting principles or generally accepted auditing standards that have been questioned

Providing all professional personnel with access to adequate and current reference materials.

Including all relevant facts, circumstances, the professional literature used, and conclusions reached in the engagement documentation of the work performed and conclusions reached.

Documenting the issue on which consultation was sought and the results of the consultation, including any decisions taken, the basis for those decisions, and how they were implemented. If there is an unresolved disagreement, an outside source may be consulted to assist in determining the appropriate application of accounting principles.

3.41 Policy 8: The firm deals with and resolves differences of opinion, documents and implements conclusions reached, and does not release the report until the matter is resolved. Single office CPA Firm implements this policy through the following procedures:

- Requiring that all differences of professional judgment among members of an engagement team be resolved by the engagement and the quality control partners, and the managing partner if necessary, and that the report not be released until the matter is resolved.

- Requiring that conclusions reached be appropriately documented. If members of the team continue to disagree with the resolution, they may disassociate themselves from the resolution of the matter and may document that a disagreement continues to exist.

3.42 Policy 9: The firm has criteria for determining whether an engagement quality control review should be performed, evaluates all engagements against the criteria, performs an engagement quality control review for all engagements that meet the criteria, and completes the review before the report is released. Single office CPA Firm implements this policy through the following procedures:

- Establishing criteria such as the following:
  — The identification of unusual circumstances or risks in an engagement or class of engagements as determined by the engagement partner or quality control partner
  — An engagement quality control review is required by law or regulation

- Evaluating all engagements against the criteria

- Performing an engagement quality control review for all engagements that meet the criteria
3.43 Policy 10: The firm establishes procedures addressing the nature, timing, extent, and documentation of the engagement quality control review. Single office CPA Firm implements this policy through the following procedures:

- Implementing procedures addressing the nature, timing, and extent of the review. The firm has concluded that performing an engagement quality control review is not necessary to obtain sufficient appropriate audit evidence for audit engagements; therefore, the engagement quality control review does not need to be completed before the date of the auditor’s report. When the engagement quality control review results in additional audit procedures being performed, the date of the auditor’s report is changed to the date by which sufficient appropriate audit evidence has been obtained. The firm’s procedures require that for audit and attestation engagements, the engagement quality control reviewer do the following:
  
  — Discuss significant accounting, auditing, and financial reporting issues with the engagement partner, including matters for which there has been consultation.
  
  — Discuss with the engagement partner the engagement team’s identification and audit of high-risk assertions, transactions and account balances.
  
  — Confirm with the engagement partner that there are no significant unresolved issues.
  
  — Review selected working papers relating to the significant judgments the engagement team made and the conclusions they reached.
  
  — Review documentation of the resolution of significant accounting, auditing, or financial reporting issues, including documentation of consultation with firm personnel or external sources.
  
  — Review the summary of uncorrected misstatements related to known and likely mis-statements.
  
  — Review additional engagement documentation to the extent considered necessary.
  
  — Read the financial statements and the report and consider whether the report is appropriate.
  
  — Complete the review before the release of the report. The review may be conducted at appropriate stages during the engagement.
  
  — Determine whether the issues raised in the review indicate a need to change the auditor’s report date.

- Resolving conflicting opinions between the engagement partner and the engagement quality control reviewer regarding significant matters. The policy requires documentation of the resolution of conflicting opinions before the release of the audit report.

- Implementing procedures addressing documentation by the engagement quality control reviewer. The firm’s procedures require documentation of the following:
  
  — The procedures required by the firm’s policies on engagement quality control review have been performed.
  
  — The engagement quality control review has been completed before the report is released.
  
  — No matters have come to the attention of the engagement quality control reviewer that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

3.44 Policy 11: The firm establishes criteria for the eligibility of engagement quality control reviewers. Single office CPA Firm implements this policy by establishing the following criteria for an engagement quality control reviewer:

- Is selected by the quality control partner or the managing partner
• Has sufficient technical expertise and experience
• Carries out his or her responsibilities with objectivity and due professional care without regard to the relative positions of the audit engagement partner and the engagement quality control reviewer
• Meets the independence requirements relating to the engagements reviewed, even though the engagement quality control reviewer is not a member of the engagement team
• Does not make decisions for the engagement team or participate in the performance of the engagement except that the engagement partner may consult the engagement quality control reviewer at any stage during the engagement

When the firm does not have suitably qualified personnel to perform the engagement quality control review, the firm contracts with a suitably qualified external person to perform the engagement quality control review.

Monitoring

3.45 The objective of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm’s quality control system, and a firm’s compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

• Adherence to professional standards and regulatory and legal requirements
• Whether the quality control system has been appropriately designed and effectively implemented
• Whether the firm’s quality control policies and procedures have been operating effectively so that reports that are issued by the firm are appropriate in the circumstances

3.46 Single office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 3.47–.56.

3.47 Policy 1: The firm assigns responsibility for the monitoring process, including performance, to a partner or competent individual. Single office CPA Firm implements this policy through the following procedures:

• Designating a partner or senior personnel to be responsible for quality assurance, including ensuring that the firm’s quality control policies and procedures and its methodologies remain relevant and adequate. Factors to be considered include the following:
  — Mergers and divestitures of portions of the practice
  — Changes in professional standards or other regulatory requirements applicable to the firm’s practice
  — Results of inspections and peer reviews
  — Review of litigation and regulatory enforcement actions against the firm and its personnel
  — Changes in applicable AICPA membership requirements
• Determining whether personnel have been appropriately informed of their responsibilities for maintaining the firm’s standards of quality in performing their duties.
• Identifying the need to do the following:
  — Revise policies and procedures related to the other elements of quality control because they are ineffective or inappropriately designed.
  — Improve compliance with firm policies and procedures related to the other elements of quality control.
Policy 2: The firm performs monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm’s quality control policies and procedures.

For purposes of illustrating Policy 2, two scenarios are described. Scenario 1 illustrates how Single office CPA Firm would satisfy the objective of Policy 2 by reviewing engagements throughout the year. Scenario 2 illustrates how Single office CPA Firm would implement Policy 2 by performing an annual inspection, thereby reviewing engagements during a designated period in the year.

Scenario 1: Monitoring by Reviewing Engagements Throughout the Year. Single office CPA Firm implements Policy 2 through the following procedures:

- Designating a partner or management-level individual not previously associated with the engagement to perform either a preissuance or postissuance review of the engagement.
- Establishing the approach for performing preissuance or postissuance reviews, for example, the comprehensiveness of the review and the frequency for summarizing findings (such as monthly or quarterly). The comprehensiveness of the review of selected engagements is similar to that performed in an inspection or peer review.
- Designating the forms and checklists to be used during the engagement and functional element reviews and the extent of the documentation required. (Examples of functional elements are the human resources function and the firm’s library.)
- Selecting a cross-section of engagements at the beginning of the monitoring year for preissuance or postissuance review and reevaluating that selection throughout the year as circumstances dictate. Criteria used for selecting engagements include the following:
  - Significant specialized industries with emphasis on high-risk engagements
  - Audits of the financial statements of employee benefit plans
  - First-year engagements
  - Significant client engagements
  - Level of service performed (that is, audit and attest, review, or compilation)
  - Engagements performed by all partners and other management-level personnel having accounting and auditing responsibilities
  - Engagements performed under Government Auditing Standards (Yellow Book engagements)
  - Engagements for which there have been complaints or allegations from firm personnel, clients, or other third parties that the work performed by the firm failed to comply with professional standards, regulatory requirements, or the firm’s system of quality control
  - Engagements in which there were significant disagreements between the review partner and the engagement partner
- Reviewing the selected engagements. Deficiencies identified as a result of this process are summarized and evaluated to determine whether the following are necessary:
  - Additional emphasis on specific areas or industries in future engagements
  - Modifications to existing policies and procedures to prevent the deficiencies noted from recurring
- Reviewing other engagement files at least annually for compliance with the firm’s quality control policies and procedures including reviewing correspondence regarding consultation on independence, integrity, and objectivity matters (for example, assessments of significant clients) and acceptance and continuance decisions.
Reviewing the resolution of matters reported by professional personnel regarding independence to determine that matters have been appropriately considered and resolved.

Preparing a summary of the deficiencies noted resulting from the preissuance and postissuance reviews so that the partner may incorporate any recommended changes into the firm’s policies and procedures.

Communicating to all professional personnel the deficiencies noted and related changes in quality control procedures.

Following up on planned corrective actions to determine whether the actions were taken as planned and whether they achieved the intended objectives.

3.51 Scenario 2: Monitoring by Inspecting a Sample of Engagements During a Designated Period of the Year.

Single office CPA Firm implements Policy 2 through the following procedures:

Designating a partner to be responsible for performing an annual inspection using guidance prepared by the AICPA for performing inspection procedures. These procedures include reviewing a cross-section of engagements using the following criteria in selecting engagements:

- Significant specialized industries with emphasis on high-risk engagements
- Audits of the financial statements of employee benefit plans
- First-year engagements
- Significant client engagements
- Level of service performed (that is, audit and attest, review, or compilation)
- Engagements performed by all partners and other management-level personnel having accounting and auditing responsibilities
- Engagements performed under Government Auditing Standards (Yellow Book engagements)
- Engagements for which there have been complaints or allegations from firm personnel, clients, or other third parties that the work performed by the firm failed to comply with professional standards, regulatory requirements, or the firm’s system of quality control
- Engagements in which there were significant disagreements between the quality review partner and the engagement partner

Establishing an approach and timetable for performing the inspection procedures and determining the forms and checklists to be used during the inspection and the extent of documentation required.

Deciding how long to retain detailed inspection documentation (as opposed to summaries).

Reviewing correspondence regarding consultation on independence, integrity, and objectivity matters and acceptance and continuance decisions.

Reviewing the resolution of matters reported by professional personnel regarding independence to determine that matters have been appropriately considered and resolved.

Selecting a sample of engagements for review to determine compliance with the firm’s quality control policies and procedures, reevaluating that selection throughout the process, and reviewing the selected engagements.

Preparing a summary inspection report for the partner or management group that evaluates the overall results of the inspection and sets forth any recommended changes that should be made to the firm’s policies and procedures.

Reviewing the recommended corrective actions and reaching final conclusions about the actions to be taken.

Communicating inspection findings and quality control changes to all professional personnel.
• Following up on planned corrective actions to determine whether those actions were taken and whether they achieved the intended objective(s).

3.52 In addition to the procedures described under Scenarios 1 or 2, Single office CPA Firm also implements Policy 2 through the following procedures:

• Reviewing and evaluating firm practice aids, such as audit programs, forms, and checklists, and considering whether they reflect recent professional pronouncements

• Providing information during staff meetings regarding new professional standards, regulatory requirements, and the related changes that should be made to firm practice aids

• Reviewing, or designating a management-level individual to be responsible for reviewing, the professional development policies and procedures to determine whether they are appropriate, effective, and meet the needs of the firm

• Reviewing, or designating a management-level individual to review summaries of the CPE records of the firm’s professional personnel to evaluate each individual’s compliance with the requirements of the AICPA and other applicable regulators

• Reviewing other administrative and personnel records pertaining to the quality control elements

• Soliciting information from the firm’s personnel during staff meetings regarding the effectiveness of training programs

3.53 Policy 3: The firm communicates (a) deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action to relevant engagement partners and other appropriate personnel and (b) the results of the monitoring of its quality control system process to relevant firm personnel at least annually. Single office CPA Firm implements this policy through the following procedures:

• Preparing a summary report for the partners that evaluates the overall results of the monitoring and sets forth any recommended changes that should be made to the firm’s policies and procedures

• Reviewing the recommended corrective actions and reaching final conclusions as to the actions to be taken

• Communicating to all professional personnel the deficiencies noted and the related changes in quality control procedures

• Following up on planned corrective actions to determine whether those actions were taken and whether they achieved the intended objective(s)

3.54 Policy 4: The firm deals appropriately with complaints and allegations. Single office CPA Firm implements this policy through the following procedures:

• Having the managing partner inform personnel that they may raise any concerns regarding complaints or allegations about noncompliance with professional standards, regulatory and legal requirements, or the firm’s system of quality control with any partner without fear of reprisals.

• Having a partner who is not otherwise involved in the engagement investigate the following:
  — Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements
  — Allegations of noncompliance with the firm’s system of quality control
  — Deficiencies in the design or operation of the firm’s quality control policies and procedures, or noncompliance with the firm’s system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations

• Documenting complaints and allegations and the responses to them.
3.55 Policy 5: The firm prepares appropriate documentation to provide evidence of the operation of each element of its system of quality control. Single office CPA Firm implements this policy by designing its summary monitoring report to provide evidence of the operation of each element of its system of quality control, including the following:

- Monitoring procedures, including the procedure for selecting completed engagements to be inspected
- A record of the evaluation of the following:
  - Adherence to professional standards and regulatory and legal requirements
  - Whether the quality control system has been appropriately designed and effectively implemented
  - Whether the firm’s quality control policies and procedures have been appropriately applied so that reports that are issued by the firm or engagement partners are appropriate in the circumstances
- Identification of the deficiencies noted, an evaluation of their effects, and the basis for determining whether further action is necessary and what that action should be

3.56 Policy 6: The firm retains documentation providing evidence of the operation of the system of quality control for an appropriate period of time. Single office CPA Firm implements this policy by requiring retention of the summary monitoring report for a period of time sufficient to meet the firm’s peer review or other regulatory requirements.
Chapter 4:
System of Quality Control for a CPA Firm’s Accounting Practice—Sole Practitioner

4.01 This chapter describes how a sole practitioner (Sole Practitioner, CPA) implements each element of quality control in her accounting practice. Sole Practitioner, CPA, is a hypothetical firm of which Sole Practitioner, CPA, is the sole owner. The firm has no professional staff; however, on occasion Sole Practitioner, CPA, hires per-diem professionals. Her accounting practice consists only of engagements subject to SSARs. She uses practice aids that have been subjected to peer review in accordance with standards established by the AICPA. Sole Practitioner, CPA, uses per-diem personnel to assist her and recognizes that her policies and procedures would have to change if she were to perform audit or attest engagements or hire full-time or part-time professional staff.

Quality Control Policies and Procedures

4.02 The firm’s system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those policies. The policies and procedures are required to be documented. Sole Practitioner, CPA, documents her system of quality control by filling out checklists and questionnaires such as those included in the AICPA Peer Review Program Manual. Sole Practitioner, CPA, reviews the documentation at least annually and updates it as necessary.

4.03 The firm should communicate its quality control policies and procedures to its personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve
- The message that each individual has a personal responsibility for quality

4.04 Sole Practitioner, CPA, meets this requirement with regard to herself by annually reviewing the checklists and questionnaires used to document each element of her system of quality control. Sole Practitioner, CPA, communicates her policies and procedures to per-diem professionals when they are initially contracted for an engagement by holding a discussion with them and follows up on individual engagements. Sole Practitioner, CPA, requires per-diem personnel to be familiar with and to comply with these policies and procedures.

Leadership Responsibilities for Quality Within the Firm (the “Tone at the Top”)

4.05 The objective of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. Sole Practitioner, CPA, satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 4.06–.08.

4.06 Policy 1: I am ultimately responsible for the firm’s system of quality control. Sole Practitioner, CPA, implements this policy through the following procedures:

- Accepting responsibility for the firm’s system of quality control
- Educating herself about requirements for a system of quality control
- Designing and implementing policies and procedures required for her firm’s system of quality control

4.07 Policy 2: Commercial considerations do not override the quality of the work performed. Sole Practitioner, CPA, implements this policy by continually evaluating client relationships and specific engagements so that commercial considerations do not override the objectives of the system of quality control.

AICPA Audit and Accounting Manual

AAM §10,200 4.07
4.08 Policy 3: I devote sufficient and appropriate resources for the development, communication, and support of the firm’s quality control policies and procedures. Sole Practitioner, CPA, implements this policy by reviewing and updating the quality control policies, procedures, and documentation on an annual basis.

Relevant Ethical Requirements

4.09 The objective of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Sole Practitioner, CPA, satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 4.10–13.

4.10 Policy 1: I adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the GAO, and any other applicable regulators. Sole Practitioner, CPA, implements this policy through the following procedures:

- Subscribing to the AICPA Professional Standards service.
- Consulting the AICPA Web site for information about changes in professional ethics and independence standards.
- Reviewing unpaid client fees to ascertain whether any outstanding amounts impair the firm’s independence.
- Reviewing relevant pronouncements published in the Journal of Accountancy relating to independence, integrity, and objectivity and retaining relevant issues of the Journal of Accountancy.
- Attending periodic professional training in ethics and independence.
- Complying with SSARSs by disclosing in the accountant’s compilation report instances in which the firm is not independent.
- Considering the significance of each client to the firm. In broad terms, the significance of a client to a firm refers to relationships that could diminish a practitioner’s objectivity and independence in performing attest services. In determining the significance of a client, the firm considers (a) the amount of time the partner devotes to the engagement and (b) the effect that losing the client would have on the firm.

4.11 Policy 2: I communicate independence requirements to per-diem professionals. Sole Practitioner, CPA, implements this policy by making per-diem personnel aware of financial, family, business, and other relationships that may be prohibited by applicable requirements.

4.12 Policy 3: I establish procedures to identify and evaluate possible threats to independence and objectivity and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards. I withdraw from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied. Sole Practitioner, CPA, implements this policy through the following procedures:

- Considering relevant information about client engagements, including the scope of services, to enable her to evaluate the overall impact on independence
- Consulting with AICPA Ethics Hotline with concerns about possible threats to independence
- Accumulating and communicating relevant information to per-diem personnel as appropriate so that the following can occur:
  - Sole Practitioner, CPA, and per-diem personnel can readily determine whether they satisfy independence requirements.
  - Sole Practitioner, CPA, can maintain and update information relating to independence.
  - Sole Practitioner, CPA, can take appropriate action regarding identified threats to independence.
• Requiring per-diem personnel to promptly notify her of independence breaches of which they become aware, and circumstances and relationships that create a threat to independence, so that appropriate action can be taken

• Documenting any safeguards applied to eliminate threats to independence or reduce them to an acceptable level

• Withdrawing from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied

4.13 Policy 4: I confirm, in writing, my compliance with policies and procedures on independence and require written confirmation from all per-diem professionals required to be independent by relevant requirements. Sole Practitioner, CPA, implements this policy by signing a step on each engagement program attesting to her independence and requiring per-diem personnel to do the same.

Acceptance and Continuance of Client Relationships and Specific Engagements

4.14 The objective of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm’s client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client’s management could reflect the reliability of the client’s accounting records and financial representations and, therefore, affect the firm’s reputation or involvement in litigation. A firm’s policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

• has considered the integrity of the client, including the identity and business reputation of the client’s principal owners, key management, related parties and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;

• is competent to perform the engagement and has the capabilities and resources to do so;

• can comply with legal and ethical requirements; and

• has reached an understanding with the client regarding the services to be performed.

4.15 Sole Practitioner, CPA, satisfies this objective, both with respect to the initial period for which the firm is performing its service and for subsequent periods, by establishing and maintaining the policies and procedures described in paragraphs 4.16–.20.

4.16 Policy 1: I evaluate factors that have a bearing on management’s integrity and consider the risk associated with providing professional services in particular circumstances. Sole Practitioner, CPA, implements this policy through the following procedures:

• Obtaining information such as the following before accepting or continuing a client:
  — The nature and purpose of the services to be provided
  — The identity of the client’s principal owners, key management, related parties, and those charged with its governance
  — The nature of the client’s operations, including its business practices, from sources such as prior-year reports, internally generated financial statements (if applicable), income tax returns, and credit reports
  — Information concerning the attitude of the client’s principal owners, key management, and those charged with its governance toward such matters as aggressive interpretation of accounting standards and internal control over financial reporting

• Inquiring of third parties such as bankers, factors, and legal counsel about management’s business reputation and integrity.
• Communicating with the predecessor accountant when required or suggested by professional standards.\(^1\)

• Evaluating the information obtained regarding management’s integrity.

• Evaluating the risk of providing review services to significant clients or to other clients for which Sole Practitioner’s, CPA, objectivity or the appearance of independence may be impaired. In determining the significance of a client, Sole Practitioner, CPA, considers the amount of time she devotes to the engagement and the effect that losing the client would have on her practice.

4.17 Policy 2: I evaluate whether the engagement can be completed with professional competence; undertake only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluate, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued. Sole Practitioner, CPA, implements this policy through the following procedures:

• Establishing a cut-off date by which evaluations of engagements should be performed, for example, before work on the current-year engagement begins

• Considering conditions, such as the following, that require reevaluation of a client or specific engagement and obtaining the relevant information to determine whether the relationship should be continued:
  — Significant changes in the client, for example, a major change in ownership, senior client personnel, directors, advisers, the nature of the business, or the financial stability of the client.
  — Changes in the nature or scope of the engagement, including requests for additional services.
  — Client significance.
  — Matters that would have caused the firm to reject the client or engagement had such conditions existed at the time of the initial acceptance. If such matters exist, Sole Practitioner, CPA, considers the professional and legal responsibilities that apply to the circumstances and the possibility of withdrawing from the engagement or both the engagement and the client relationship.
  — The client’s delinquency in paying fees. (This also may affect the firm’s independence.)

• Determining if she has, or can reasonably obtain, the knowledge and expertise to perform the engagement

• Evaluating the information obtained regarding the engagement, making the acceptance or continuance decision, and documenting her evaluation or conclusion in a memorandum or by signing off next to the relevant item in a practice aid

4.18 Policy 3: I obtain an understanding with the client regarding the services to be performed. Sole Practitioner, CPA, implements this policy through the following procedures:

• Adhering to all requirements set forth in professional standards regarding obtaining an understanding with the client

• Requiring that the understanding with the client be documented either through an engagement letter or in a memorandum

\(^1\) AR section 400, *Communications Between Predecessor and Successor Accountants* (AICPA, Professional Standards, vol. 2), provides guidance on communications between a predecessor and successor accountant when the successor accountant decides to communicate with the predecessor accountant. It also requires a successor accountant who becomes aware of information that leads him or her to believe the financial statements reported on by the predecessor accountant may require revision to request that the client communicate this information to the predecessor accountant.
4.19 Policy 4: I follow established procedures on withdrawal from an engagement or from both the engagement and the client relationship. Sole Practitioner, CPA, implements this policy by discussing the issues and her conclusion with the appropriate level of the client’s management and those charged with its governance. If she considers it necessary, she also discusses her decision with her attorney.

4.20 Policy 5: I document how issues relating to acceptance or continuance of client relationships and specific engagements were resolved. Sole Practitioner, CPA, implements this policy by documenting, in a memorandum to the engagement files, significant issues, consultations, conclusions, and the basis for the conclusions relating to acceptance or continuance of client relationships and specific engagements.

Human Resources

4.21 The objective of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (a) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (b) to enable the firm to issue reports that are appropriate in the circumstances. Sole Practitioner, CPA, satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 4.22–23.

4.22 Policy 1: I hire per-diem personnel of integrity who possess the characteristics that enable them to perform competently. Sole Practitioner, CPA, implements this policy by setting criteria, regarding such factors as education, certification or licensure, and experience, that per-diem personnel must meet to be hired.

4.23 Policy 2: I maintain the knowledge, skills, and abilities required in the circumstances by participating in general and industry-specific continuing professional education (CPE) and professional development activities that enable me to accomplish my responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA societies, state boards of accountancy, and other applicable regulators. I also monitor the compliance of per-diem employees with CPE requirements. Sole Practitioner, CPA, implements this policy through the following procedures:

- Maintaining the competencies necessary to accomplish responsibilities related to each of the firm’s engagements
- Establishing a professional development program that takes into account the requirements of the AICPA and state boards of accountancy
- Participating in external professional development programs, including graduate-level and self-study courses
- Joining and becoming an active member of professional organizations
- Serving on professional committees, writing for professional publications on topics she is knowledgeable about, and participating in other professional activities
- Considering changes in the applicable professional standards when determining her professional development program
- Setting criteria that per-diem personnel must meet to competently perform engagements, such as the following examples:
  - Determining that per-diem personnel are in compliance with the applicable professional education requirements of the AICPA, state boards of accountancy, and state CPA societies
  - Obtaining and retaining documentation of such compliance
- Evaluating the knowledge and expertise required to perform an engagement prior to accepting the client or engagement
- Reading professional publications, such as state society journals, to keep abreast of changes in accounting standards and any industry-specific pronouncements that affect the client
- Consulting the AICPA Web site for information about changes in professional standards
Engagement Performance

4.24 The objective of the engagement performance element of quality control is to provide the firm with reasonable assurance (a) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements and (b) that the firm or the practitioner-in-charge issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed. Sole Practitioner, CPA, satisfies these objectives by establishing and maintaining the policies and procedures described in paragraphs 4.25–32.

4.25 Policy 1: I plan engagements to meet professional standards, regulatory requirements, and the firm’s requirements. Sole Practitioner, CPA, implements this policy by adhering to professional standards regarding the planning process and the extent of documentation of the planning, if applicable. Engagement planning considerations may include the following:

- Developing or updating client information.
- Assessing the significance of the client to her firm.
- Obtaining an engagement letter for engagements performed under SSARSs. AR section 100, Compilation and Review of Financial Statements (AICPA, Professional Standards, vol. 2), requires the accountant to either issue a compilation report or document an understanding with the entity through the use of an engagement letter when the accountant submits financial statements to a client that are not expected to be used by a third party.
- Reviewing prior financial statements and accountants’ reports.
- Using work programs and applicable reporting and disclosure checklists.

4.26 Policy 2: I perform, supervise, review, document, and report (or communicate) in accordance with the requirements of professional standards. Sole Practitioner, CPA, implements this policy through the following procedures:

- Requiring the use of appropriate practice aids in all engagements
- Maintaining the availability of current practice aids and AICPA professional standards
- Briefing per-diem personnel on the engagement so that they understand the objectives of their work
- Documenting the work performed in accordance with professional standards and the firm’s policy
- Supervising per-diem personnel as appropriate based on the following:
  - Understanding of, and practical experience with, engagements of a similar nature and complexity through appropriate training and participation
  - Understanding of professional standards and regulatory and legal requirements
  - Technical knowledge, including knowledge of relevant information technology
  - Knowledge of relevant industries in which the client operates
  - Ability to apply professional judgment
  - Understanding of the firm’s quality control policies and procedures
  - Experience level
- Reviewing and initialing all engagement documentation prepared by per-diem personnel
4.27 Policy 3: I complete the assembly of final engagement files on a timely basis. Sole Practitioner, CPA, implements this policy by completing the assembly of final engagement files on a timely basis in accordance with professional standards and applicable regulatory requirements, if any.

4.28 Policy 4: I maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation. Sole Practitioner, CPA, implements this policy through the following procedures:

- Establishing and applying controls to do the following:
  - Clearly determine when and by whom engagement documentation was prepared and reviewed.
  - Protect the integrity of the information at all stages of the engagement.
  - Prevent unauthorized changes to the engagement documentation.
  - Allow access to the engagement documentation by per-diem personnel and other authorized parties as necessary to properly discharge their responsibilities.
- Tracking the distribution of engagement documentation materials to the per-diem personnel at the start of the engagement, preparing engagement documentation during the engagement, and assembling final documentation at the end of the engagement
- Restricting access to, and enabling proper distribution and confidential storage of, hardcopy engagement documentation
- Using passwords or data encryption, or both, to restrict access to electronic engagement documentation to authorized users
- Using appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement
- Implementing procedures regarding original paper documents that have been electronically scanned or otherwise copied to another media that accomplish the following:
  - Generate copies that contain the entire content of the original paper documentation, including manual signatures, cross-references, and annotations.
  - Integrate the copies into the engagement files, including indexing and signing off on the copies as necessary.
  - Enable the copies to be retrieved and printed as necessary.

4.29 Policy 5: I retain engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations. Sole Practitioner, CPA, implements this policy through the following procedures:

- Retaining engagement documentation for a period of time sufficient to meet the requirements of the state board of accountancy and applicable professional standards
- Enabling the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation because the underlying technology may be upgraded or changed over time
- Providing, where necessary, a record of changes made to engagement documentation after the assembly of engagement files has been completed
- Enabling authorized external parties to access and review specific engagement documentation for quality control or other purposes

4.30 Policy 6: I require that consultation take place when appropriate; I make sufficient and appropriate resources available to enable appropriate consultation to take place; I provide to those consulted all the relevant facts known to me; I document the nature, scope, and conclusions of such consultations; and I implement conclusions resulting from such consultations. Sole Practitioner, CPA, implements this policy through the following procedures:
• Maintaining current technical references to assist in resolving practice problems
• Referring to the AICPA’s Technical Hotline or other qualified individuals if a practice problem arises for which the firm needs additional expertise
• Requiring that documentation of consultation include the following:
  — All relevant facts and circumstances about the issue on which consultation was sought.
  — References to professional literature used in the analysis of the matter.
  — The results of the consultation, including any decisions made, the basis for those decisions, and how they were implemented. This documentation is retained with the engagement documentation.

4.31 Policy 7: I deal with and resolve differences of opinion; I document and implement the conclusions reached; and I do not release the report until the matter is resolved. Sole Practitioner, CPA, implements this policy by (a) evaluating issues of professional judgment when differences of opinion arise with per-diem personnel, with those consulted, or with an external reviewer and (b) resolving the matter before releasing the report. If persons involved in the engagement continue to disagree with the resolution, they may disassociate themselves from the resolution of the matter and document that a disagreement continues to exist.

4.32 Policy 8: I have criteria for determining whether an engagement quality control review should be performed; I evaluate all engagements against the criteria before I accept the engagement; I contract with a qualified external person to perform the engagement quality control review; and I do not release the report until the review is completed. Sole Practitioner, CPA, implements this policy through the following procedures:
• Establishing the following criteria for determining whether an engagement quality control review should be performed:
  — The engagement is subject to Statements on Auditing Standards or Statements on Standards for Attestation Engagements.
  — An initial engagement for a client is in a specialized industry in which Sole Practitioner, CPA, has had no previous experience.
  — An engagement quality control review is required by law or regulation.
• Evaluating all engagements against the criteria
• Contracting with a qualified external person to perform the engagement quality control review
• Not releasing the report until the review is completed

Monitoring

4.33 The objective of the monitoring element of a system of quality control is to provide the firm with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm’s quality control system, and a firm’s compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:
• Adherence to professional standards and regulatory and legal requirements
• Whether the quality control system has been appropriately designed and effectively implemented
• Whether the firm’s quality control policies and procedures have been operating effectively so that reports that are issued by the firm are appropriate in the circumstances

4.34 Sole Practitioner, CPA, satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 4.35–39.
4.35 Policy 1: I perform monitoring procedures that are sufficiently comprehensive to enable me to assess compliance with all applicable professional standards and the firm’s quality control policies and procedures. Sole Practitioner, CPA, implements this policy through the following procedures:

- Performing a postissuance review of selected engagements at least annually\(^2\)
- Summarizing the findings from the firm’s monitoring procedures at least annually and considering the systemic causes of findings that indicate improvements are needed
- Determining any corrective actions or improvements to be made with respect to the specific engagements reviewed or the firm’s quality control policies and procedures and taking those actions, including necessary modifications to the quality control system, on a timely basis
- Reviewing compliance with the firm’s policies and procedures related to relevant ethical responsibilities, including independence, human resources, acceptance, and continuance of client relationships and specific engagements, and engagement performance
- Reviewing all policies and procedures and revising those affected by changes in professional standards or the nature of her practice
- Reviewing and determining that the firm’s practice aids are current and reflect recent professional pronouncements and changes in her practice
- Reviewing CPE records to determine whether the classroom training and self-study programs she uses are appropriate for the firm’s practice
- Reviewing CPE records to determine compliance with the requirements of the AICPA and other applicable regulatory agencies

4.36 Policy 2: I deal appropriately with complaints and allegations. Sole Practitioner, CPA, implements this policy through the following procedures:

- Investigating the following:
  - Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements
  - Allegations of noncompliance with the firm’s system of quality control
  - Deficiencies in the design or operation of the firm’s quality control policies and procedures, or noncompliance with the firm’s system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations
- Documenting complaints and allegations and the responses to them

4.37 Policy 3: I prepare appropriate documentation to provide evidence of the operation of each element of the firm’s system of quality control. Sole Practitioner, CPA, implements this policy by documenting evidence of the operation of each element of the firm’s system of quality control by preparing a memorandum of the following:

- Monitoring procedures, including the procedure for selecting completed engagements to be subject to postissuance review
- A record of the evaluation of the following:
  - Adherence to professional standards and regulatory and legal requirements
  - Whether the quality control system has been appropriately designed and effectively implemented

\(^2\) A postissuance review may be performed as part of an inspection. A sole proprietor may consider engaging another CPA to perform the inspection to obtain a fresh look at the engagement. See paragraph 3.32, “Scenario 2: Monitoring by Inspecting a Sample of Engagements During a Designated Period of the Year,” for a description of how a firm considers and evaluates, on an ongoing basis, compliance with a firm’s policies and procedures by performing an annual inspection. Note that a preissuance review by the sole proprietor does not satisfy the monitoring requirements.
Whether the firm’s quality control policies and procedures have been appropriately applied so that reports that are issued by the firm are appropriate in the circumstances

- Identification of the deficiencies noted, an evaluation of their effects, and the basis for determining whether further action is necessary and what that action should be

4.38 Although the form and content of that documentation is a matter of judgment, the illustration in table 1 in this chapter is an example of such documentation.

4.39 Policy 4: I retain documentation of evidence of the operation of the system of quality control for an appropriate period of time. Sole Practitioner, CPA, implements this policy by requiring retention of the summary report for a period of time sufficient to meet the firm’s peer review or other regulatory requirements.

Table 1: Summary of Quality Control Monitoring For the Calendar Year 20XX

<table>
<thead>
<tr>
<th>Element of Quality Control and Applicable Policies</th>
<th>Reviewer’s Initials and Date Reviewed</th>
<th>Location of Additional Documentation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leadership Responsibilities for Quality Within the Firm</td>
<td>JB 6/30/XX</td>
<td>These policies are evidenced by the overall operation of the firm’s system of quality control.</td>
</tr>
</tbody>
</table>

Relevant Ethical Requirements

Policy 1. Adhering to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, and other applicable regulators

Policy 2. Communicating independence requirements to per-diem professionals and, where applicable, others subject to them

Policy 3. Establishing procedures to help mitigate possible threats to my independence and objectivity

Policy 4. Confirming, in writing, my compliance with policies and procedures on independence and obtaining written confirmation from all per-diem professionals required to be independent by relevant requirements

Acceptance and Continuance of Client Relationships and Specific Engagements

Policy 1. Evaluating factors that have a bearing on management’s integrity and considering the risk associated with providing professional services in particular circumstances
<table>
<thead>
<tr>
<th>Element of Quality Control and Applicable Policies</th>
<th>Reviewer’s Initials and Date Reviewed</th>
<th>Location of Additional Documentation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Policy 2. Accepting or continuing to perform only those engagements that I can complete with professional competence and evaluating whether the relationship should be continued</td>
<td>JB 6/30/XX</td>
<td>Engagement files</td>
</tr>
<tr>
<td>Policy 3. Obtaining an understanding with the client regarding services to be performed</td>
<td>JB 6/30/XX</td>
<td>Engagement files</td>
</tr>
<tr>
<td>Policy 4. Following established procedures on withdrawal from an engagement or from both the engagement and the client relationship</td>
<td>JB 6/30/XX</td>
<td>Not applicable for year ended 20XX</td>
</tr>
<tr>
<td>Policy 5. Documenting how issues relating to acceptance or continuance of client relationships and specific engagements were resolved</td>
<td>JB 6/30/XX</td>
<td>Client acceptance files and client engagement files</td>
</tr>
</tbody>
</table>

**Human Resources**

| Policy 1. Hiring per-diem personnel of integrity who possess the characteristics that enable them to perform competently | JB 6/30/XX | Personnel files |
| Policy 2. (a) Maintaining the knowledge, skills, and abilities required in the circumstances by participating in general and industry-specific continuing professional education (CPE) and professional development activities that enable me to accomplish my responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA society, state boards of accountancy, and other applicable regulators and (b) monitoring for compliance the CPE requirements of per-diem employees | JB 6/30/XX | Personnel files |

**Engagement Performance**

| Policy 1. Planning engagements to meet professional standards, regulatory requirements, and the firm’s requirements | JB 6/30/XX | Engagement files |
| Policy 2. Performing, supervising, reviewing, documenting, and reporting (or communicating) in accordance with the requirements of professional standards | JB 6/30/XX | Engagement files |
| Policy 3. Completing the assembly of final engagement files on a timely basis | JB 6/30/XX | Engagement files |
| Policy 4. Maintaining the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation | JB 6/30/XX | Engagement files |

(continued)
<table>
<thead>
<tr>
<th>Element of Quality Control and Applicable Policies</th>
<th>Reviewer's Initials and Date Reviewed</th>
<th>Location of Additional Documentation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Policy 5. Retaining engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations</td>
<td>JB 6/30/XX</td>
<td>Engagement files</td>
</tr>
<tr>
<td>Policy 6. Requiring that consultation take place when appropriate; making sufficient and appropriate resources available to enable appropriate consultation to take place; providing to those consulted all the relevant facts known to me; documenting the nature, scope, and conclusions of such consultations; and implementing conclusions resulting from such consultations</td>
<td>JB 6/30/XX</td>
<td>Engagement files</td>
</tr>
<tr>
<td>Policy 7. Dealing with and resolving differences of opinion; documenting and implementing the conclusions reached; and not releasing the report until the matter is resolved</td>
<td>JB 6/30/XX</td>
<td>Engagement files</td>
</tr>
<tr>
<td>Policy 8. Evaluating all engagements against my criteria for an engagement quality control review; contracting with a qualified external person to perform the engagement quality control review; and not releasing the report until the review is completed</td>
<td>JB 6/30/XX</td>
<td>Client acceptance files</td>
</tr>
</tbody>
</table>

Monitoring

| Policy 1. Performing monitoring procedures that are sufficiently comprehensive to enable me to assess compliance with all applicable professional standards and the firm’s quality control policies and procedures | JB 6/30/XX | Monitoring files |
| Policy 2. Dealing appropriately with complaints and allegations | JB 6/30/XX | Engagement files |
| Policy 3. Preparing appropriate documentation to provide evidence of the operation of each element of the firm’s system of quality control | JB 6/30/XX | Monitoring files |
| Policy 4. Retaining documentation of evidence of the operation of the system of quality control for an appropriate period of time | JB 6/30/XX | Monitoring files |
Chapter 5:
System of Quality Control for an Alternative Practice Structure

5.01 An alternative practice structure, as referred to in this practice aid, is a nontraditional structure in the practice of public accounting that contains an attest and a nonattest portion. The attest portion is conducted through a firm owned and controlled by CPAs (a closely aligned CPA firm). The nonattest portion is conducted through a separate issuer or nonissuer firm owned and controlled by individuals who are not CPAs (a non-CPA-owned entity\(^1\)). The non-CPA-owned entity may be an issuer or a nonissuer. Alternative practice structures are described in Interpretation 101-14, “The effect of alternative practice structures on the applicability of independence rules,” under Rule 101, Independence (AICPA, Professional Standards, vol. 2, ET sec. 101 par. .16), which is included as appendix B of this practice aid.

5.02 The quality control policies and procedures established by a closely aligned CPA firm that may or may not perform audit services are illustrated in chapters 2–3, as applicable. Additional quality control policies and procedures relevant to alternative practice structures may be necessary when certain portions of the CPA firm’s system of quality control (a) reside at the non-CPA-owned entity or (b) operate in conjunction with the system of quality control of the non-CPA-owned entity.

5.03 Elements of quality control that might reside in a non-CPA-owned entity include the following:
- Relevant ethical requirements
- Human resources
- Monitoring of relevant ethical requirements and human resources

For example, the non-CPA-owned entity may be responsible for hiring personnel for both firms.

5.04 This chapter describes how Non-CPA-Owned Entity and Closely Aligned CPA Firm, hypothetical firms that are organized in an alternative practice structure, implement incremental quality control policies and procedures to address the previously mentioned elements of quality control that reside at Non-CPA-Owned Entity. Closely Aligned CPA Firm has no issuer clients\(^2\) and implements the policies and procedures described in chapter 2 of this practice aid.

Quality Control Policies and Procedures

5.05 Policy 1: The top-tier company\(^3\) maintains a system of quality control. Non-CPA-Owned Entity implements this policy through the following procedures:
- Designating a qualified individual to be responsible for the following:
  - Designing and directing the quality control activities at the top-tier company
  - Disseminating information to all subsidiaries and affiliated entities, all subsidiaries associated with CPA firms, and all CPA firms closely aligned with company subsidiaries
- Providing all company personnel and indirect superiors\(^4\) with access to the company’s quality control policies and procedures

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\(^1\) A non-CPA-owned entity is an entity that is closely aligned to a CPA firm through common employment; leasing of employees, equipment, or facilities; or other similar arrangements. In addition to one or more professional service subsidiaries or divisions that offer nonattest professional services (for example, tax, personal financial planning, and management consulting), a non-CPA-owned entity may have subsidiaries or divisions such as a bank, insurance company, or broker-dealer.

\(^2\) If the closely aligned CPA firm were to be engaged to perform audit services for an issuer, the non-CPA-owned entity or its affiliated companies might need to revise their quality control policies and procedures to comply with Public Company Accounting Oversight Board (PCAOB) standards and to reflect Securities and Exchange Commission (SEC) requirements applicable to audits of issuers.

\(^3\) The top-tier company is the parent company of the non-CPA-owned entity, which may be an issuer.

\(^4\) Indirect superiors may be involved in regional management of direct superiors; thus, they may need to adhere to requirements.
Relevant Ethical Requirements

5.06 The objective of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Closely Aligned CPA Firm satisfies this objective by ensuring that Non-CPA-Owned Entity establishes and maintains the policies and procedures described in paragraphs 5.07–.09.

5.07 Policy 1: Non-CPA-Owned Entity adheres to applicable relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the GAO, and any other applicable regulators. Non-CPA-Owned Entity implements this policy through the following procedures:

- Developing policies and procedures to ensure the independence of Closely Aligned CPA Firm as required by the applicable aforementioned regulators. (Non-CPA-Owned Entity is required to be independent only in the context of its alignment with the CPA firm; it does not perform any attest functions, so its independence is not relevant.)
- Designating an officer to be responsible for providing guidance, answering questions, monitoring compliance, and resolving matters concerning independence, integrity, and objectivity of Closely Aligned CPA Firm.
- Determining when consultation with outside sources regarding independence, integrity, and objectivity matters is required.
- Reviewing written representations from direct superiors and indirect superiors and others as applicable and resolving potential independence, integrity, and objectivity matters.
- Maintaining documentation of the resolution of independence, integrity, and objectivity matters.
- Requiring entity personnel to obtain sufficient training and education to accomplish their responsibilities with respect to independence, integrity, and objectivity.
- Obtaining from Closely Aligned CPA Firm a current list of all entities with which firm personnel are prohibited from having a financial or business relationship.
- Obtaining written representations from personnel of Non-CPA-Owned Entity, upon hire and on an annual basis, stating that they are familiar with and in compliance with Non-CPA-Owned Entity’s policies and procedures regarding independence, integrity, and objectivity.

5.08 Policy 2: Personnel of Non-CPA-Owned Entity are familiar with policies and procedures regarding relevant ethical requirements. Non-CPA-Owned Entity implements this policy through the following procedures:

- Providing all of its personnel with access to its policies and procedures and guidance materials related to independence, integrity, and objectivity, such as manuals, memoranda, and databases containing professional and regulatory literature
- Advising personnel of Non-CPA-Owned Entity of the financial or other relationships, circumstances, or activities involving either individuals or entities that may be prohibited, as in the following examples:

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5 Direct superiors are defined to include those persons so closely associated with a partner or manager who is a covered member that such persons can directly control the activities of such partner or manager. For this purpose, a person who can directly control is the immediate superior of the partner or manager who has the power to direct the activities of that person so as to be able to directly or indirectly (for example, through another entity over which the direct superior can exercise significant influence) derive a benefit from that person’s activities. Examples would be the person who has day-to-day responsibility for the activities of the partner or manager and is in a position to recommend promotions and compensation levels. Indirect superiors are those persons who are one or more levels above direct superiors. Generally, this would start with persons in an organization structure to whom direct superiors report and go up the line from there.

6 Examples of business relationships prohibited by independence standard-setting bodies such as the AICPA, the Government Accountability Office, and the U.S. Department of Labor because they might impair independence include being an investor in a joint venture with a client that is material or serving as a board member on the board of an audit client.
— Business relationships with Closely Aligned CPA Firm’s clients or with nonclients that have investor or investee relationships with Closely Aligned CPA Firm’s clients
— Loans to and from Closely Aligned CPA Firm’s clients, including loans from Closely Aligned CPA Firm’s financial institution clients
— Family members who are employed by Closely Aligned CPA Firm’s clients or who serve as director, officer, manager, or in other audit-sensitive positions with clients of Closely Aligned CPA Firm, including not-for-profit organizations
— Past due fees from Closely Aligned CPA Firm’s clients
— Services in which the service provider assumes some of the responsibilities of client management
— Performing certain bookkeeping services for governmental entities that are clients of Closely Aligned CPA Firm
— Client relationships with Non-CPA-Owned Entity in which Closely Aligned CPA Firm leases employees, facilities, and so on
— Situations in which personnel of Non-CPA-Owned Entity act as promoters, underwriters, voting trustees, directors, or officers of Closely Aligned CPA Firm’s clients
— Direct and material indirect financial interests in clients of Closely Aligned CPA Firm
— Material investments by Closely Aligned CPA Firm’s clients in Non-CPA-Owned Entity that allow the clients to exercise significant influence over Non-CPA-Owned Entity

• Advising personnel of Non-CPA-Owned Entity of the following:
  — All direct superiors with whom, and all activities in which, Non-CPA-Owned Entity is prohibited from engaging, as defined in Non-CPA-Owned Entity’s independence policies and procedures
  — All indirect superiors with whom, and all activities in which, Non-CPA-Owned Entity is prohibited from engaging, as defined by Non-CPA-Owned Entity’s policies and procedures

• Obtaining client lists from Closely Aligned CPA Firm to inform all personnel, on a timely basis, of Closely Aligned CPA Firm client’s to which independence policies apply

• Obtaining documented representations from all Non-CPA-Owned Entity personnel (including those defined as direct and indirect superiors or supervisors of affiliated issuers),7 on an annual basis thereafter, stating that they are familiar with and in compliance with policies and procedures regarding relevant ethical requirements

5.09 Policy 3: Non-CPA-Owned Entity identifies and evaluates possible threats to independence and objectivity and takes appropriate action to eliminate those threats or reduce them to an appropriate level by applying safeguards. Non-CPA-Owned Entity implements this policy through the following procedures:

• Assigning responsibility for obtaining, maintaining, and reviewing documented representations from all Non-CPA-Owned Entity personnel (see paragraph 5.08) for completeness and resolving reported exceptions with Non-CPA-Owned Entity’s chief executive

• Requiring the chief executive of Non-CPA-Owned Entity to review or to designate an appropriate individual to review unpaid fees from clients of Closely Aligned CPA Firm to ascertain whether any outstanding amounts impair Closely Aligned CPA Firm’s independence

• Requiring all professionals to report, on a timely basis when identified, circumstances and relationships that form a threat to independence so that appropriate action can be taken

7 Affiliated issuers include the top-tier company and all entities consolidated in the top-tier company’s financial statements. Individuals in these entities are not in situations in which a direct superior can exercise significant influence.
- Requiring all professionals to report, on a timely basis when identified, apparent violations of independence, integrity, or objectivity policies involving themselves, their spouses, or their dependents and the corrective actions taken or proposed to be taken

Human Resources

5.10 The objective of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (a) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (b) to enable the firm to issue reports that are appropriate in the circumstances. Closely Aligned CPA Firm satisfies this objective by ensuring that Non-CPA-Owned Entity establishes and maintains the policies and procedures comparable to those that are described in paragraphs 5.11–.13 with regard to its leased or per-diem personnel.

5.11 Policy 1: Leased or per-diem personnel possess characteristics that enable them to competently perform and review engagements. Non-CPA-Owned Entity implements this policy by having knowledge and experience equivalent to that of Closely Aligned CPA Firm to make the following decisions:

- Designating an individual from Closely Aligned CPA Firm to be responsible for hiring and managing human resources within Non-CPA-Owned Entity on behalf of Closely Aligned CPA Firm.
- Reviewing Closely Aligned CPA Firm’s personnel requirements for attest engagements to ensure that sufficient and capable staff persons are available to perform those engagements.
- Involving members of Closely Aligned CPA Firm in the process of hiring professionals on behalf of Closely Aligned CPA Firm that include establishing the attributes, achievements, and experiences desired in entry-level and experienced personnel. Such criteria assist in evaluating (a) the personal characteristics of professionals, such as integrity, competence, and motivation, and (b) whether professionals can competently perform responsibilities within Closely Aligned CPA Firm.
- Establishing guidelines for additional procedures to be performed when hiring experienced personnel, such as performing background checks and inquiring about any outstanding regulatory actions.
- Establishing criteria for determining which individuals will be involved in interviewing and hiring personnel on behalf of Closely Aligned CPA Firm.

5.12 Policy 2: Leased or per-diem personnel participate in general and industry-specific continuing professional education (CPE) and other professional activities that enable them to accomplish assigned responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA societies, state accountancy boards, and other regulatory agencies. Non-CPA-Owned Entity implements this policy through the following procedures:

- Designating an individual to be responsible for CPE and professional development activities, including maintaining appropriate documentation evidencing that leased and per-diem personnel have met the professional education requirements of the AICPA, state boards of accountancy, and other applicable regulators
- Establishing policies that require individuals performing audits, reviews, compilations, or attestation engagements for Closely Aligned CPA Firm to participate in CPE related to accounting and auditing
- Establishing policies requiring all leased or per-diem personnel to be in compliance with the professional education requirements of the boards of accountancy in states where they are licensed and with the AICPA, state societies, and other regulatory agencies, as applicable
- Establishing an orientation and training policy for new hires who will perform audits, reviews, compilations, or attestation engagements for Closely Aligned CPA Firm or who will have partner- or manager-level responsibility for the overall supervision or review of such engagements
• Ensuring that leased or per-diem personnel are informed about changes in accounting and auditing standards, independence, integrity, and objectivity requirements, and Closely Aligned CPA Firm’s technical policies and procedures that are relevant to them

• Encouraging leased or per-diem personnel to participate in other professional activities, such as graduate-level courses, membership in professional organizations, and serving on professional committees

5.13 Policy 3: Leased or per-diem personnel who are selected for advancement have the qualifications to accomplish the responsibilities they will be called upon to assume. Factors to consider include the degree of technical training and proficiency required in the circumstances and the nature and extent of supervision of assignments relating to audits, reviews, compilations, or attestation engagements performed by Closely Aligned CPA Firm. Non-CPA-Owned Entity implements this policy through the following procedures:

• Establishing a system for providing information to Closely Aligned CPA Firm so that it can make appropriate personnel decisions, such as assignments for audits, reviews, compilations, and attestation engagements.

• Designating an individual to be responsible for the following:
  — Establishing criteria for the evaluation and advancement of leased or per-diem personnel, including appropriate documentation
  — Making advancement and termination decisions, including identifying responsibilities and requirements for evaluation, at each professional level and deciding who will prepare those evaluations
  — Developing appropriate evaluation forms
  — Reviewing performance evaluations with personnel, discussing future objectives of Closely Aligned CPA Firm and the individual, and discussing assignment preferences
  — Periodically evaluating owners of Closely Aligned CPA Firm by means of peer evaluation or self-appraisal
  — Counseling leased or per-diem personnel regarding their progress and career opportunities

• Establishing an arrangement with Closely Aligned CPA Firm in which a supervisory-level individual of Closely Aligned CPA Firm is responsible for assisting Non-CPA-Owned Entity in making advancement and termination decisions concerning leased or per-diem personnel. This would include evaluating personnel needs, establishing hiring objectives, and providing final approval.

• Developing a system for evaluating the performance of leased or per-diem personnel and advising them of their progress.

Monitoring

5.14 The objective of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm’s quality control system, and a firm’s compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

• Adherence to professional standards and regulatory and legal requirements
• Whether the quality control system has been appropriately designed and effectively implemented
• Whether the firm’s quality control policies and procedures have been operating effectively so that reports that are issued by the CPA firm are appropriate in the circumstances
5.15 A CPA firm that is closely aligned with a non-CPA-owned entity satisfies this objective by ensuring that the non-CPA-owned entity establishes and maintains the policies and procedures described in paragraphs 5.16–19.

5.16 Policy 1: Non-CPA-Owned Entity considers and evaluates, on an ongoing basis, the relevance and adequacy of its policies and procedures related to relevant ethical requirements that are applicable to all its personnel and its personnel management policies and procedures that are applicable to leased or per-diem personnel. Non-CPA-Owned Entity implements this policy by designating qualified individuals to be responsible for monitoring quality assurance, including ensuring that Non-CPA-Owned Entity’s quality control guidance is regularly updated to reflect changes in professional standards related to independence, CPE, and other regulatory requirements through the following procedures:

- Implementing a system of ongoing monitoring of the effectiveness and appropriateness of policies and procedures related to independence, objectivity, and integrity as applicable to all personnel of Non-CPA-Owned Entity and compliance with those policies and procedures
- Ensuring, on an ongoing basis, that guidance materials and any practice aids Non-CPA-Owned Entity provides to Closely Aligned CPA Firm are appropriately designed to assist Closely Aligned CPA Firm in adhering to quality control standards
- Maintaining a system to ensure that the practice aids regarding independence and other technical matters provided by Non-CPA-Owned Entity are updated to reflect current professional standards and regulatory requirements and are relevant to and effective for Closely Aligned CPA Firm’s practice
- Ensuring that Non-CPA-Owned Entity informs and provides guidance to leased or per-diem personnel regarding new professional standards, regulatory requirements, and related changes to relevant Closely Aligned CPA Firm policies or practice aids

5.17 Policy 2: Non-CPA-Owned Entity considers and evaluates, on an ongoing basis, compliance with its policies and procedures related to relevant ethical requirements that are applicable to all of its personnel and personnel management policies and procedures that are applicable to leased or per-diem personnel. Non-CPA-Owned Entity implements this policy by considering and evaluating, on an ongoing basis, compliance with policies and procedures related to independence, integrity, and objectivity, as applicable to all of its personnel, through the following procedures:

- Performing timely monitoring of policies and procedures, on an ongoing basis, related to independence, integrity, and objectivity to evaluate compliance with those policies and procedures. The monitoring policies and procedures could include an internal audit function, ongoing review by senior management, or engaging an independent CPA to examine and report on compliance.
- Summarizing and communicating the results of the monitoring to all of its personnel and communicating any suggested changes to policies and procedures to the appropriate levels of personnel in Non-CPA-Owned Entity.
- Correcting noted deficiencies based on the results of the monitoring to ensure compliance with policies and procedures.

5.18 Policy 3: Non-CPA-Owned Entity deals appropriately with complaints and allegations. Non-CPA-Owned Entity implements this policy through the following procedures:

- Performing timely monitoring of policies and procedures, on an ongoing basis, related to independence, integrity, and objectivity to evaluate compliance with those policies and procedures. The monitoring policies and procedures could include an internal audit function, ongoing review by senior management, or engaging an independent CPA to examine and report on compliance.
- Having the firm’s ethics committee (excluding any members who are otherwise involved in the engagement under investigation) investigate the following:
— Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements
— Allegations of noncompliance with the firm’s system of quality control
— Deficiencies in the design or operation of the firm’s quality control policies and procedures, or noncompliance with the firm’s system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations

• Documenting complaints and allegations and the responses to them.

5.19 Policy 4: Non-CPA-Owned Entity prepares appropriate documentation to provide evidence of the operation of each element of its system of quality control. Non-CPA-Owned Entity implements this policy by preparing and retaining documentation that provides evidence of the operation of the system of quality control for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm’s compliance with its system of quality control.
Appendix A:

Statement on Quality Control Standards (SQCS) No. 7,
A Firm’s System of Quality Control

Supersedes SQCSs Nos. 2–6. SQCS No. 1 was previously superseded by SQCS No. 2.

Source: SQCS No. 7.

Effective date: Applicable to a CPA firm’s system of quality control for its accounting and auditing practice as of January 1, 2009.

Introduction

.01 The purpose of this section is to establish standards and provide guidance for a CPA firm’s responsibilities for its system of quality control for its accounting and auditing practice. This section describes elements of quality control and other matters essential to the effective design, implementation, and maintenance of the system. This section is to be read in conjunction with the AICPA Code of Professional Conduct.

.02 This section also sets forth the meaning of certain terms used in SQCSs issued by the Auditing Standards Board in describing the professional requirements imposed on firms and engagement partners.

System of Quality Control

.03 The firm must establish a system of quality control designed to provide the firm with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements, and that the firm or engagement partners issue reports that are appropriate in the circumstances. A system of quality control consists of policies designed to achieve these objectives and the procedures necessary to implement and monitor compliance with those policies.

.04 The nature of the policies and procedures developed by individual firms to comply with this section will depend on various factors such as the size and operating characteristics of the firm. The system of quality control should be designed to provide the firm with reasonable assurance that the segments of the firm’s engagements performed by its foreign member firms or offices or by its domestic or foreign affiliates,
if any, are performed in accordance with professional standards in the United States when such standards are applicable.

Definitions

.05 In this section, the following terms have the meanings given:

a. **Accounting and auditing practice.** A practice that performs engagements covered by this section, which are audit, attestation, compilation, review and any other services for which standards have been established by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under Rules 201 or 202 of the AICPA Code of Professional Conduct (ET sections 201–202). Although standards for other engagements may be established by other AICPA technical committees, engagements performed in accordance with those standards are not encompassed in the definition of an accounting and auditing practice.

b. **Engagement documentation.** The record of work performed, results obtained, and conclusions the practitioner reached, also known as working papers or workpapers.

c. **Engagement partner.** An individual responsible for supervising engagements covered by this section and signing or authorizing an individual to sign the report on such engagements, and who, where required, has the appropriate authority from a professional, legal or regulatory body. Firms may use different titles to refer to individuals with this authority.

d. **Engagement quality control review.** A process designed to provide an objective evaluation, by an individual or individuals who are not members of the engagement team, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.

e. **Engagement quality control reviewer.** A partner, other person in the firm, qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to perform the engagement quality control review.

f. **Engagement team.** All personnel performing the engagement, excluding those who perform the engagement quality control review. The engagement team (i) includes all employees and contractors retained by the firm who perform engagement procedures, irrespective of their functional classification (for example, audit, tax, or management consulting services) and (ii) excludes specialists as discussed in AU section 336, *Using the Work of a Specialist*, and individuals who perform only routine clerical functions, such as word processing and photocopying.

g. **Firm.** A form of organization permitted by law or regulation whose characteristics conform to resolutions of the Council of the American Institute of Certified Public Accountants that is engaged in the practice of public accounting.

h. **Inspection.** A retrospective evaluation of the adequacy of the firm’s quality control policies and procedures, its personnel’s understanding of those policies and procedures and the extent of the firm’s compliance with them. Inspection is an element of monitoring.

i. **Monitoring.** A process comprising an ongoing consideration and evaluation of the firm’s system of quality control, the objective of which is to enable the firm to obtain reasonable assurance that its system of quality control is designed appropriately and operating effectively.

j. **Partner.** An individual with authority to bind the firm with respect to the performance of a professional services engagement. For purposes of this definition, partner may include an employee with this authority who has not assumed the risks and benefits of ownership. Firms may use different titles to refer to individuals with this authority.

k. **Personnel.** All individuals who perform professional services for which the firm is responsible, whether or not they are CPAs.
Professional standards. Standards established by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under Rules 201 or 202 of the AICPA Code of Professional Conduct or other standard setting bodies that set auditing and attest standards applicable to the engagement being performed.

Qualified external person. An individual outside the firm with the capabilities and competence to act as an engagement partner.

Reasonable assurance. In the context of this standard, a high, but not absolute, level of assurance.

Relevant ethical requirements. Ethical requirements to which the firm and its personnel are subject, which consist of the AICPA Code of Professional Conduct together with rules of state boards of accountancy and applicable regulatory agencies, which may be more restrictive.

Staff. Personnel, other than partners and engagement partners, including any specialists who are employees of the firm.

Professional Requirements

SQCSs contain professional requirements together with related guidance in the form of explanatory material. Firms have a responsibility to consider the entire text of an SQCS with regard to their system of quality control and in understanding and applying the professional requirements of the relevant SQCSs.

Not every paragraph of an SQCS carries a professional requirement that the firm is expected to fulfill. Rather, the professional requirements are communicated by the language and the meaning of the words used in the SQCSs.

SQCSs use two categories of professional requirements, identified by specific terms, to describe the degree of responsibility they impose on firms, as follows:

- Unconditional requirements. The firm is required to comply with an unconditional requirement in all cases in which the circumstances exist to which the unconditional requirement applies. SQCSs use the words must or is required to indicate an unconditional requirement.

- Presumptively mandatory requirements. The firm is also required to comply with a presumptively mandatory requirement in all cases in which the circumstances exist to which the presumptively mandatory requirement applies; however, in rare circumstances, the firm may depart from a presumptively mandatory requirement provided the practitioner documents his or her justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement. SQCSs use the word should to indicate a presumptively mandatory requirement.

If an SQCS provides that a procedure or action is one that the firm “should consider,” the consideration of the procedure or action is presumptively required, whereas carrying out the procedure or action is not. The professional requirements of an SQCS are to be understood and applied in the context of the explanatory material that provides guidance for their application.

Explanatory Material

Explanatory material is defined as the text within an SQCS (excluding any related interpretations) that may:

- Provide further explanation and guidance on the professional requirements; or
- Identify and describe other procedures or actions relating to the activities of the firm.

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1 Interpretive publications differ from explanatory material. Interpretive publications, for example, interpretations of the SQCSs, reside outside of the standards section of an SQCS and are recommendations on the application of the SQCS in specific circumstances. In contrast, explanatory material is always contained within the standards sections of the SQCS and is meant to be more descriptive in nature.
Explanatory material that provides further explanation and guidance on the professional requirements is intended to be descriptive rather than imperative. That is, it explains the objective of the professional requirements (where not otherwise self-evident); it explains why the firm might consider or employ particular procedures, depending on the circumstances; and it provides additional information for the firm to consider in exercising professional judgment with regard to its system of quality control.

Explanatory material that identifies and describes other procedures or actions relating to the activities of the firm is not intended to impose a professional requirement for the firm to perform the suggested procedures or actions. Rather, these procedures or actions require the firm’s attention and understanding; how and whether the firm carries out such procedures or actions with regard to its system of quality control depends on the exercise of professional judgment in the circumstances consistent with the objective of the standard. The words may, might, and could are used to describe these actions and procedures.

Documentation and Communication of Quality Control Policies and Procedures

The firm should document its quality control policies and procedures. The size, structure, and nature of the practice of the firm are important considerations in determining the extent of the documentation of established quality control policies and procedures. For example, documentation of established quality control policies and procedures would generally be expected to be more extensive in a large firm than in a small firm and in a multi-office firm than in a single-office firm.

The firm should communicate its quality control policies and procedures to its personnel. Although communication is enhanced if it is in writing, the communication of quality control policies and procedures is not required to be in writing. Effective communication of the firm’s quality control policies and procedures:

- Describes the quality control policies and procedures and the objectives they are designed to achieve;
- Includes the message that each individual has a personal responsibility for quality and is expected to be familiar with and to comply with these policies and procedures; and
- Stresses the importance of obtaining feedback on its system of quality control from its personnel and encourages its personnel to communicate their views or concerns on quality control matters.

Elements of a System of Quality Control

The firm’s system of quality control should include policies and procedures addressing each of the following elements:

a. Leadership responsibilities for quality within the firm (the "tone at the top")
b. Relevant ethical requirements
c. Acceptance and continuance of client relationships and specific engagements
d. Human resources
e. Engagement performance
f. Monitoring

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

The firm should promote an internal culture based on the recognition that quality is essential in performing engagements and should establish policies and procedures to support that culture. Such policies...
and procedures should require the firm’s leadership (managing partner or board of managing partners, chief executive officer, or equivalent) to assume ultimate responsibility for the firm’s system of quality control.

.16 The firm’s leadership and the examples it sets significantly influence the internal culture of the firm. The promotion of a quality-oriented internal culture depends on clear, consistent, and frequent actions and messages from all levels of the firm’s management that emphasize the firm’s quality control policies and procedures, and the requirement to:

a. Perform work that complies with professional standards and regulatory and legal requirements.

b. Issue reports that are appropriate in the circumstances.

Such actions and messages encourage a culture that recognizes and rewards quality work. These actions and messages may be communicated by training seminars, meetings, formal or informal dialogue, mission statements, newsletters, or briefing memoranda. They may be incorporated in the firm’s internal documentation and training materials, and in partner and staff appraisal procedures such that they will support and reinforce the firm’s view on the importance of quality and how, practically, it is to be achieved.

.17 Of particular importance in promoting an internal culture based on quality is the need for the firm’s leadership to recognize that the firm’s business strategy is subject to the overarching requirement for the firm to achieve the objectives of the system of quality control in all the engagements that the firm performs. Accordingly, the firm should establish policies to:

a. Assign management responsibilities so that commercial considerations do not override the quality of work performed;

b. Address performance evaluation, compensation, and advancement (including incentive systems) with regard to its personnel, to demonstrate the firm’s overarching commitment to the objectives of the system of quality control; and

c. Devote sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.

.18 Any person or persons assigned operational responsibility for the firm’s quality control system by the firm’s leadership should have sufficient and appropriate experience and ability to identify and understand quality control issues and to develop appropriate policies and procedures, as well as the necessary authority to implement those policies and procedures.

Relevant Ethical Requirements

.19 The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

.20 The AICPA Code of Professional Conduct establishes the fundamental principles of professional ethics, which include:

- Responsibilities
- The public interest
- Integrity
- Objectivity and independence
- Due care
- Scope and nature of services

.21 The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel, and, where applicable, others subject to independence requirements, maintain independence where required. Independence requirements are set forth in Rule 101 (ET section 101) and its
related interpretations and rulings of the AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies. Guidance on threats to independence, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and safeguards to mitigate such threats involving matters that are not explicitly addressed in the Code of Professional Conduct, are set forth in the AICPA’s Conceptual Framework for AICPA Independence Standards. Such policies and procedures should enable the firm to:

a. Communicate its independence requirements to its personnel and, where applicable, others subject to them.

b. Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if effective safeguards cannot be applied, withdrawing from the engagement.\(^2\)

.22 Such policies and procedures should require:

a. The engagement partner to consider relevant information about client engagements, including the scope of services, to enable him or her to evaluate the overall effect, if any, on independence requirements.

b. Personnel to promptly notify the engagement partner and the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken.

c. The accumulation and communication of relevant information to appropriate personnel so that:

(i) The firm, the engagement partner, and other firm personnel can readily determine whether they satisfy independence requirements;

(ii) The firm can maintain and update information relating to independence; and

(iii) The firm and the engagement partner can take appropriate action regarding identified threats to independence.

.23 The firm should establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements, and to enable it to take appropriate actions to resolve such situations. The policies and procedures should include requirements for:

a. Personnel to promptly notify the firm of independence breaches of which they become aware.

b. The firm to promptly communicate identified breaches of these policies and procedures and the required corrective actions to:

(i) The engagement partner who, with the firm, has the responsibility to address the breach; and

(ii) Other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action.

c. Confirmation to the firm by the engagement partner and the other individuals referred to in subparagraph b.(ii) that the required corrective actions have been taken.

.24 At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by the requirements set forth in Rule 101 and its related interpretations and rulings of the AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies. Written confirmation may be in paper or electronic form.

\(^2\) An accountant is not precluded from issuing a report with respect to a compilation of financial statements for an entity with respect to which the accountant is not independent. If the accountant is not independent, disclosure of the accountant’s lack of independence is the appropriate response.
.25 The purpose of obtaining confirmation and taking appropriate action on information indicating noncompliance is to demonstrate the importance that the firm attaches to independence and keep the issue current for and visible to its personnel.

.26 For all audit or attestation engagements where regulatory or other authorities require the rotation of personnel after a specified period, the firm’s policies and procedures should address these requirements.

Acceptance and Continuance of Client Relationships and Specific Engagements

.27 The firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where the firm:

a. Has considered the integrity of the client, including the identity and business reputation of the client’s principal owners, key management, related parties, and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;
b. Is competent to perform the engagement and has the capabilities and resources to do so; and
c. Can comply with legal and ethical requirements.

The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.

.28 To minimize the risk of misunderstandings regarding the nature, scope, and limitations of the services to be performed, policies and procedures should provide for obtaining an understanding with the client regarding those services. Professional standards may provide guidance in deciding whether the understanding should be oral or written.

.29 When issues have been identified, and the firm has decided to accept or continue the client relationship or a specific engagement, the firm should document how the issues were resolved.

.30 Factors to consider regarding the integrity of a client include:

- The nature of the client’s operations, including its business practices.
- Information concerning the attitude of the client’s principal owners, key management, and those charged with its governance toward such matters as aggressive interpretation of accounting standards and internal control over financial reporting.

The extent of knowledge a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

.31 Matters to consider in accepting or continuing the client engagement include whether:

- Firm personnel have knowledge of relevant industries or subject matters or the ability to effectively gain the necessary knowledge;
- Firm personnel have experience with relevant regulatory or reporting requirements, or the ability to effectively gain the necessary competencies;
- The firm has sufficient personnel with the necessary capabilities and competence;
- Specialists are available, if needed;
- Individuals meeting the criteria and eligibility requirements to perform an engagement quality control review are available, where applicable; and
- The firm is able to complete the engagement within the reporting deadline.
.32 If a potential conflict of interest is identified in accepting an engagement from a new or an existing client, the firm should determine whether it is appropriate to accept the engagement. Where the engagement is accepted, the firm should consider any ethical requirements that exist under AICPA Interpretation No. 102-2, “Conflicts of Interest,” under Rule 102, Integrity and Objectivity (ET section 102), such as disclosure of the relationship to the client and other appropriate parties.

.33 Deciding whether to continue a client relationship includes consideration of significant issues that have arisen during the current or previous engagements, and their implications for continuing the relationship.

.34 If the firm obtains information that would have caused it to decline an engagement if that information had been available earlier, policies and procedures on the continuance of the engagement and the client relationship should include consideration of the professional and legal responsibilities that apply to the circumstances, and the possibility of withdrawing from the engagement or from both the engagement and the client relationship.

.35 Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship should include documenting significant issues, consultations, conclusions, and the basis for the conclusions. Policies and procedures may include:

- Discussing with the appropriate level of the client’s management and those charged with its governance the appropriate action that the firm might take based on the relevant facts and circumstances.
- Considering whether there is a professional, regulatory, or legal requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.
- If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client’s management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship.

.36 In certain situations, the auditor may be appointed by statutory procedures or required by law or regulation to perform the engagement. Accordingly, certain of the considerations regarding the acceptance and continuance of client relationships and specific engagements, as set out in paragraphs .27–.35, may not be relevant. Nonetheless, establishing policies and procedures as described may provide valuable information to public sector auditors in performing risk assessments and in carrying out reporting responsibilities.

**Human Resources**

.37 The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to:

- Perform its engagements in accordance with professional standards and regulatory and legal requirements, and
- Enable the firm to issue reports that are appropriate in the circumstances.

.38 Such policies and procedures should address the following:

- Recruitment and hiring, if applicable;
- Determining capabilities and competencies;
- Assigning personnel to engagements, if applicable;
- Professional development; and
• Performance evaluation, compensation, and advancement.

Recruitment and Hiring

.39 Effective recruitment processes and procedures help the firm select individuals of integrity, who have the capacity to develop the capabilities and competence necessary to perform the firm’s work, and possess the appropriate characteristics to enable them to perform competently. Examples of such characteristics may include meeting minimum academic requirements established by the firm, maturity, integrity, and leadership traits.

Determining Capabilities and Competencies

.40 Capabilities and competencies are the knowledge, skills, and abilities that qualify personnel to perform an engagement covered by this section. Capabilities and competencies are not measured by periods of time because such a quantitative measurement may not accurately reflect the kinds of experiences gained by personnel in any given time period. Accordingly, for purposes of this section, a measure of overall competency is qualitative rather than quantitative.

.41 Capabilities and competence are developed through a variety of methods; for example:

• Professional education
• Continuing professional development, including training
• Work experience
• Mentoring by more experienced staff; for example, other members of the engagement team

Competencies of Engagement Partner

.42 A firm’s quality control policies and procedures should provide reasonable assurance that an engagement partner possesses the competencies necessary to fulfill his or her engagement responsibilities.

.43 In most cases, an engagement partner will have gained the necessary competencies through relevant and appropriate experience in engagements covered by this section. In some cases, however, an engagement partner may have obtained the necessary competencies through disciplines other than the practice of public accounting, such as in relevant industry, governmental, and academic positions. When necessary, the experience of the engagement partner may be supplemented by continuing professional education (CPE) and consultation. The following are examples.

• An engagement partner whose recent experience has consisted primarily in providing tax services may acquire the competencies necessary in the circumstances to perform a compilation or review engagement by obtaining relevant CPE.
• An engagement partner whose experience consists of performing review and compilation engagements may be able to obtain the necessary competencies to perform an audit by becoming familiar with the industry in which the client operates, obtaining CPE relating to auditing, using consulting sources during the course of performing the audit engagement, or any combination of these.
• A person in academia might obtain the necessary competencies to perform engagements covered by this section by (a) obtaining specialized knowledge through teaching or authorship of research projects or similar papers and (b) performing a rigorous self-study program, or by engaging a consultant to assist on such engagements.

.44 The characteristics of a particular client, industry, and the kind of service being provided determine the nature and extent of competencies established by a firm that are expected of the engagement partner for an engagement. For example:
• The competencies expected of an engagement partner for an engagement to compile financial statements would be different than those expected of a practitioner engaged to review or audit financial statements.

• Supervising engagements and signing or authorizing others to sign reports for clients in certain industries or engagements, such as financial services, governmental, or employee benefit plan engagements, would require different competencies than those expected in performing attest services for clients in other industries.

• The engagement partner for an attestation engagement to examine management’s assertion about the effectiveness of an entity’s internal control over financial reporting would be expected to have technical proficiency in understanding and evaluating the effectiveness of controls, while an engagement partner for an attestation engagement to examine investment performance statistics would be expected to have different competencies, including an understanding of the subject matter of the underlying assertion.

In practice, the competency requirements necessary for the engagement partner are broad and varied in both their nature and number. Required competencies include the following, as well as other competencies as necessary in the circumstances.

• Understanding of the role of a system of quality control and the Code of Professional Conduct. An understanding of the role of a firm’s system of quality control and the AICPA’s Code of Professional Conduct, both of which play critical roles in assuring the integrity of the various kinds of reports.

• Understanding of the service to be performed. An understanding of the performance, supervision, and reporting aspects of the engagement. This understanding is usually gained through actual participation under appropriate supervision in that type of engagement.

• Technical proficiency. An understanding of the applicable professional standards including those standards directly related to the industry in which a client operates and the kinds of transactions in which a client engages.

• Familiarity with the industry. An understanding of the industry in which a client operates, to the extent required by professional standards applicable to the kind of service being performed. In performing an audit or review of financial statements, this understanding would include an industry’s organization and operating characteristics sufficient to identify areas of high or unusual risk associated with an engagement and to evaluate the reasonableness of industry-specific estimates.

• Professional judgment. Skills that indicate sound professional judgment. In performing engagements covered by this section, such skills would typically include the ability to exercise professional skepticism and identify areas requiring special consideration including, for example, the evaluation of the reasonableness of estimates and representations made by management and the determination of the kind of report appropriate in the circumstances.

• Understanding the organization’s information technology systems. A sufficient understanding of how the organization is dependent on or enabled by information technologies and the manner in which the information systems are used to record and maintain financial information, to determine when involvement of an IT professional is necessary for an audit engagement.

Interrelationship of Competencies and Other Elements of a Firm’s System of Quality Control

The competencies listed above are interrelated and gaining one particular competency may be related to achieving another. For example, familiarity with the client’s industry interrelates with a practitioner’s ability to make professional judgments relating to the client.

In establishing policies and procedures related to the nature of competencies needed by the engagement partner for an engagement, a firm may consider the requirements of policies and procedures established for other elements of quality control. For example, a firm might consider its requirements related...
to engagement performance in determining the nature of competency requirements that describe the degree of technical proficiency necessary in a given set of circumstances.

The Relationship of the Competency Requirement of the Uniform Accountancy Act to the Human Resource Element of Quality Control

.48 CPAs are required to follow the accountancy laws of the individual licensing jurisdictions in the United States that govern the practice of public accounting. These jurisdictions may have adopted, in whole or in part, the Uniform Accountancy Act (UAA), which is a model legislative statute and related administrative rules designed by the AICPA and the National Association of State Boards of Accountancy (NASBA) to provide a uniform approach to the regulation of the accounting profession. The UAA provides that “any individual licensee who is responsible for supervising attest or compilation services and signs or authorizes someone to sign the accountant’s report on the financial statements on behalf of the firm shall meet the competency requirements set out in the professional standards for such services.” A firm’s compliance with this section is intended to enable a practitioner who performs the services described in the preceding sentence on the firm’s behalf to meet the competency requirement referred to in the UAA.

Assignment of Engagement Teams

.49 The firm should assign responsibility for each engagement to an engagement partner and should establish policies and procedures requiring that:

a. The identity and role of the engagement partner are communicated to management and those charged with governance;

b. The engagement partner has the appropriate capabilities, competence, authority, and time to perform the role; and

c. The responsibilities of the engagement partner are clearly defined and communicated to that individual.

.50 Policies and procedures may include systems to monitor the workload and availability of engagement partners so as to enable these individuals to have sufficient time to adequately discharge their responsibilities.

.51 The firm should establish policies and procedures to assign appropriate staff with the necessary capabilities, competence, and time to:

a. Perform engagements in accordance with professional standards and regulatory and legal requirements; and

b. Enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

.52 When assigning engagement teams, and in determining the level of supervision required, the firm might consider factors such as the engagement team’s:

• Understanding of, and practical experience with, engagements of a similar nature and complexity through appropriate training and participation.

• Understanding of professional standards and regulatory and legal requirements.

• Technical knowledge and expertise, including knowledge of relevant information technology.

• Knowledge of relevant industries in which the client operates.

• Ability to apply professional judgment.

• Understanding of the firm’s quality control policies and procedures.
Generally, as the ability and experience levels of assigned staff increase, the need for direct supervision decreases.

.53 Appropriate teamwork and training assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

Professional Development

.54 The continuing competence of the firm’s personnel depends to a significant extent on an appropriate level of continuing professional development so that personnel maintain their knowledge and capabilities. Effective policies and procedures emphasize the need for all levels of firm personnel to participate in general and industry-specific continuing professional education and other professional development activities that enable them to fulfill responsibilities assigned, and to satisfy applicable continuing professional education requirements of the AICPA and regulatory agencies. Effective policies and procedures also place importance on passing the Uniform CPA Examination. The firm may provide the necessary training resources and assistance to enable personnel to develop and maintain the required capabilities and competence. The firm may use an external source that is qualified for that purpose if internal technical and training resources are unavailable, or for any other reason.

Performance Evaluation, Compensation, and Advancement

.55 The firm’s policies and procedures should provide that personnel selected for advancement have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume.

.56 Effective performance evaluation, compensation, and advancement procedures give due recognition and reward to the development and maintenance of competence and commitment to ethical principles. Steps a firm may take in developing and maintaining competence and commitment to ethical principles include:

* Making personnel aware of the firm’s expectations regarding performance and ethical principles;
* Providing personnel with evaluation of, and counseling on, performance, progress, and career development; and
* Helping personnel understand that their compensation and advancement to positions of greater responsibility depend upon, among other things, performance quality and adherence to ethical principles, and that failure to comply with the firm’s policies and procedures may result in disciplinary action.

The size and circumstances of the firm are important considerations in determining the structure of the firm’s performance evaluation process. Smaller firms, in particular, may employ less formal methods of evaluating the performance of their personnel.

Engagement Performance

.57 The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are consistently performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances. Required policies and procedures should address:

a. Engagement performance,

b. Supervision responsibilities, and

c. Review responsibilities.

.58 Effective policies and procedures facilitate consistency in the quality of engagement performance. This may be accomplished through written or electronic manuals, software tools or other forms of
standardized documentation, and industry- or subject-matter-specific guidance materials. The firm might address, for example:

- How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work,
- Processes for complying with applicable engagement standards,
- Processes of engagement supervision, staff training, and mentoring,
- Methods of reviewing the work performed, the significant judgments made, and the type of report being issued,
- Appropriate documentation of the work performed and of the timing and extent of the review,
- Appropriate communication of the results of each engagement, and
- Processes to keep all policies and procedures current.

.59 Policies and procedures for engagement supervision might include:

- Tracking the progress of the engagement;
- Considering the capabilities and competence of individual members of the engagement team, whether they have sufficient time to carry out their work, whether they understand their instructions, and whether the work is being carried out in accordance with the planned approach to the engagement;
- Addressing significant issues arising during the engagement, considering their significance, and appropriately modifying the planned approach; and
- Identifying matters for consultation or consideration by more-experienced engagement team members during the engagement.

.60 Review responsibility policies and procedures should be determined on the basis that qualified engagement team members, which may include the engagement partner, review work performed by other team members on a timely basis.

.61 A review may include consideration of whether, for example:

- The work has been performed in accordance with professional standards and regulatory and legal requirements;
- Significant findings and issues have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- The nature, timing, and extent of work performed is appropriate and without need for revision;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to support the report; and
- The objectives of the engagement procedures have been achieved.

.62 The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis, as appropriate for the nature of the engagement, after the engagement reports have been released. Professional standards, laws, or regulations may prescribe the time limits by which the assembly of final engagement files for specific types of engagements is to be completed.
Confidentiality, Safe Custody, Integrity, Accessibility, and Retrievability of Engagement Documentation

.63 The firm should establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.

.64 Relevant ethical requirements establish an obligation for the firm’s personnel to observe at all times the confidentiality of information contained in engagement documentation, unless specific client authority has been given to disclose information or there is a legal or professional duty to do so. Specific laws or regulations may impose additional obligations on the firm’s personnel to maintain client confidentiality, particularly where data of a personal nature are concerned.

.65 Whether engagement documentation is in paper, electronic, or other media, the integrity, accessibility, and retrievability of the underlying data may be compromised if the documentation could be altered, added to, or deleted without the firm’s knowledge, or could be permanently lost or damaged. Appropriate and reasonable controls for engagement documentation may include those that:

- Clearly determine when and by whom engagement documentation was prepared or reviewed;
- Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via electronic means;
- Prevent unauthorized changes to the engagement documentation; and
- Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

.66 Controls that the firm may design and implement to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation may include, for example:

- The use of a password by engagement team members and data encryption to restrict access to electronic engagement documentation to authorized users;
- Appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement;
- Procedures for properly distributing engagement documentation to the team members at the start of the engagement, processing it during the engagement, and collating it at the end of the engagement; and
- Procedures for restricting access to and enabling proper distribution and confidential storage of hardcopy engagement documentation.

.67 For practical reasons, original paper documentation may be electronically scanned or otherwise copied to another media for inclusion in engagement files. In that case, the firm should establish procedures designed to maintain the integrity, accessibility, and retrievability of the documentation.

.68 These procedures may include, for example:

- Generating scanned copies that reflect the entire content of the original paper documentation, including manual signatures, cross-references and annotations;
- Integrating the scanned copies into the engagement files, including indexing and signing off on the copies as necessary; and
- Enabling the scanned copies to be retrieved and printed as necessary.

There may be legal, regulatory, or other reasons to retain original paper documentation.
Retention of Engagement Documentation

.69 The firm should establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm, professional standards, laws, and regulations.

.70 In determining the needs of the firm for retention of engagement documentation and the period of such retention, the firm may consider the nature of the engagement and the firm’s circumstances; for example, whether the engagement documentation is needed to provide a record of matters of continuing significance to future engagements. The retention period may also depend on other factors, such as whether professional standards, laws, or regulations prescribe specific retention periods for certain types of engagements, or whether there are generally accepted retention periods in the absence of specific legal or regulatory requirements.

.71 Procedures that the firm may adopt for retention of engagement documentation include those that:

- Enable the retrieval of and access to the engagement documentation during the retention period, particularly in the case of electronic documentation, as the underlying technology may be upgraded or changed over time.
- Provide, where necessary, a record of changes made to engagement documentation after the assembly of engagement files has been completed.
- Enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.

Consultation

.72 The firm should establish policies and procedures designed to provide it with reasonable assurance that:

a. Consultation takes place when appropriate (for example, when dealing with complex, unusual, unfamiliar, difficult, or contentious issues);

b. Sufficient and appropriate resources are available to enable appropriate consultation to take place;

c. All the relevant facts known to the engagement team are provided to those consulted;

d. The nature and scope of such consultations are documented, and are understood by both the individual seeking consultation and the individual consulted; and

e. The conclusions resulting from such consultations are documented and implemented.

.73 Consultation includes discussion, at the appropriate professional level, with individuals within or outside the firm who have relevant specialized expertise.

.74 Consultation uses appropriate research resources as well as the collective experience and technical expertise of the firm. Consultation helps to promote quality and improves the application of professional judgment. Appropriate recognition of consultation in the firm’s policies and procedures helps to promote a culture in which consultation is recognized as a strength and encourages personnel to consult on complex, unusual, unfamiliar, difficult, or contentious issues.

.75 The firm’s consultation procedures should provide for consultation with those having appropriate knowledge, seniority, and experience within the firm (or, where applicable, outside the firm) on significant technical, ethical, and other matters, and for appropriate documentation and implementation of conclusions resulting from consultations.

.76 A firm needing to consult externally may take advantage of advisory services provided by other firms, professional and regulatory bodies, or commercial organizations that provide relevant quality control
services. Before using such services, the firm should evaluate whether the external provider is qualified for that purpose.

.77 Documentation of consultations with other professionals that involve complex, unusual, unfamiliar, difficult, or contentious matters that is sufficiently complete and detailed contributes to an understanding of:

- The issue on which consultation was sought; and
- The results of the consultation, including any decisions made, the basis for those decisions, and how they were implemented.

**Differences of Opinion**

.78 The firm should establish policies and procedures for dealing with and resolving differences of opinion within the engagement team, with those consulted, and, where applicable, between the engagement partner and the engagement quality control reviewer (including a qualified external person). Such policies and procedures should require that:

a. Conclusions reached be documented and implemented; and

b. The report not be released until the matter is resolved.

.79 Effective procedures encourage identification of differences of opinion at an early stage, provide clear guidelines about the successive steps to be taken thereafter, and require documentation regarding the resolution of the differences and the implementation of the conclusions reached. Procedures to resolve such differences may include consulting with another practitioner or firm, or a professional or regulatory body.

**Engagement Quality Control Review**

.80 The firm should establish criteria against which all engagements covered by this section are to be evaluated to determine whether an engagement quality control review should be performed.

.81 The firm’s policies and procedures should require that if an engagement meets the criteria established, an engagement quality control review be performed for that engagement, and that the review be completed before the report is released.

.82 The firm’s policies and procedures should require the engagement partner to remain responsible for the engagement and its performance, notwithstanding involvement of the engagement quality control reviewer.

.83 The structure and nature of the firm’s practice are important considerations in establishing criteria to consider when determining which engagements are to be subject to an engagement quality control review. Such criteria may include:

- The nature of the engagement, including the extent to which it involves a matter of public interest;
- The identification of unusual circumstances or risks in an engagement or class of engagements; and
- Whether laws or regulations require an engagement quality control review.

.84 If the firm has no engagements that meet the criteria, paragraphs .85–.99 do not apply.

**Nature, Timing, and Extent of the Engagement Quality Control Review**

.85 The engagement quality control review procedures should include an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report.
The engagement quality control review should include reading the financial statements or other subject matter information and the report and considering whether the report is appropriate.

An engagement quality control review also should include a review of selected engagement documentation relating to the significant judgments the engagement team made and the conclusions they reached, and should include a discussion with the engagement partner regarding significant findings and issues. The extent of the engagement quality control review may depend upon, among other things, the complexity of the engagement and the risk that the report might not be appropriate in the circumstances.

An engagement quality control review may include consideration of the following:

- The engagement team’s evaluation of the firm’s independence in relation to the specific engagement;
- Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters and the conclusions arising from those consultations; and
- Whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached.

Significant judgments made by the engagement team may include, for example:

- Significant risks identified during the engagement and the responses to those risks.
- Judgments made, particularly with respect to materiality and significant risks.
- The significance and disposition of corrected and uncorrected misstatements identified during the engagement.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.

The firm’s policies and procedures should require the engagement quality control reviewer to conduct the review in a timely manner so that significant issues may be promptly resolved to the reviewer’s satisfaction before the report is released. The review may be conducted at appropriate stages during the engagement.

When the engagement quality control reviewer makes recommendations that the engagement partner does not accept and the matter is not resolved to the reviewer’s satisfaction, the firm’s procedures for dealing with differences of opinion apply (see paragraphs .78–.79).

Criteria for the Eligibility of Engagement Quality Control Reviewers

The firm should establish policies and procedures addressing

a. The appointment of engagement quality control reviewers; and
b. The technical qualifications required to perform the role, including the necessary experience and authority.

The firm’s policies and procedures on the technical qualifications of engagement quality control reviewers may address the technical expertise, experience, and authority necessary to fulfill the role. What constitutes sufficient and appropriate technical expertise, experience, and authority depends on the circumstances of the engagement.

The firm should establish policies and procedures designed to maintain the objectivity of the engagement quality control reviewer. Such policies and procedures should provide that while the engagement quality control reviewer is not a member of the engagement team, the engagement quality control reviewer should satisfy the independence requirements relating to the engagements reviewed.
Policies and procedures designed to maintain the objectivity of the engagement quality control reviewer may include a requirement, where practicable, that the engagement quality control reviewer is not selected by the engagement partner, and requirements that the engagement quality control reviewer not:

a. Participate in the performance of the engagement except as discussed in paragraph .96 or

b. Make decisions for the engagement team.

It may not be practicable, in the case of firms with few partners, for the engagement partner not to be involved in selecting the engagement quality control reviewer.

The engagement partner may consult the engagement quality control reviewer at any stage during the engagement, for example, to establish that a judgment made by the engagement partner will be acceptable to the engagement quality control reviewer. Such consultation need not impair the engagement quality control reviewer’s eligibility to perform the role. However, when the nature and extent of the consultations become significant, the reviewer’s objectivity may be impaired unless both the engagement team and the reviewer are careful to maintain the reviewer’s objectivity.

The firm’s policies and procedures should provide for the replacement of the engagement quality control reviewer when the reviewer’s ability to perform an objective review has been impaired.

Qualified external persons may be contracted when sole practitioners or small firms identify engagements requiring engagement quality control reviews. Alternatively, some sole practitioners or small firms may wish to use other firms to facilitate engagement quality control reviews. When the firm contracts qualified external persons or other firms, the requirements and guidance in paragraphs .85–.97 apply.

Documentation of the Engagement Quality Control Review

The firm should establish policies and procedures that provide for appropriate documentation of the engagement quality control review, including documentation that:

a. The procedures required by the firm’s policies on engagement quality control review have been performed;

b. The engagement quality control review has been completed before the report is released; and

c. The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

Monitoring

The firm should establish policies and procedures designed to provide the firm and its engagement partners with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Such policies and procedures should:

a. Include an ongoing consideration and evaluation of the firm’s system of quality control to determine

(i) The appropriateness of the design and

(ii) The effectiveness of the operation of the system of quality control.

b. Assign responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility.

c. Assign performance of monitoring of the firm’s system of quality control to qualified individuals.
The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

- Adherence to professional standards and regulatory and legal requirements;
- Whether the quality control system has been appropriately designed and effectively implemented; and
- Whether the firm’s quality control policies and procedures have been operating effectively, so that reports that are issued by the firm are appropriate in the circumstances.

The evaluation may identify circumstances that necessitate changes to, or the need to improve compliance with, the firm’s policies and procedures to provide the firm with reasonable assurance that its system of quality control is effective.

The firm’s policies should require the performance of monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and regulatory requirements, and the firm’s quality control policies and procedures. Monitoring procedures include:

- Review of selected administrative and personnel records pertaining to the quality control elements.
- Review of engagement working papers, reports, and clients’ financial statements.
- Discussions with the firm’s personnel.
- Summarization of the findings from the monitoring procedures, at least annually, and consideration of the systemic causes of findings that indicate improvements are needed.
- Determination of any corrective actions to be taken or improvements to be made with respect to the specific engagements reviewed or the firm’s quality control policies and procedures.
- Communication of the identified findings to appropriate firm management personnel.
- Consideration of findings by appropriate firm management personnel who should also determine that any actions necessary, including necessary modifications to the quality control system, are taken on a timely basis.

Monitoring procedures also include an assessment of:

- The appropriateness of the firm’s guidance materials and any practice aids;
- New developments in professional standards and regulatory and legal requirements, and how they are reflected in the firm’s policies and procedures where appropriate;
- Compliance with policies and procedures on independence;
- The effectiveness of continuing professional development, including training;
- Decisions related to acceptance and continuance of client relationships and specific engagements; and
- Firm personnel’s understanding of the firm’s quality control policies and procedures, and implementation thereof.

Some of the monitoring procedures discussed above may be accomplished through the performance of:

- Engagement quality control review.
- Postissuance review of engagement working papers, reports, and clients’ financial statements for selected engagements.
- Inspection procedures.
The need for and extent of inspection procedures depends in part on the existence and effectiveness of the other monitoring procedures. The nature of inspection procedures varies based on the firm’s quality control policies and procedures and the effectiveness and results of other monitoring procedures.

The inspection of a selection of completed engagements may be performed on a cyclical basis. For example, engagements selected for inspection may include at least one engagement for each engagement partner over an inspection cycle that spans three years. The manner in which the inspection cycle is organized, including the timing of selection of individual engagements, depends on many factors, including the following:

- The size of the firm.
- The number and geographical location of offices.
- The results of previous monitoring procedures.
- The degree of authority both personnel and offices have (for example, whether individual offices are authorized to conduct their own inspections or whether only the head office may conduct them).
- The nature and complexity of the firm’s practice and organization.
- The risks associated with the firm’s clients and specific engagements.

The inspection process involves the selection of individual engagements, some of which may be selected without prior notification to the engagement team. In determining the scope of the inspections, the firm may take into account the scope or conclusions of a peer review or regulatory inspections. (See paragraph .119.)

Inspection procedures with respect to the engagement performance element of a quality control system are particularly appropriate in a firm with more than a limited number of management-level individuals responsible for the conduct of its accounting and auditing practice.

In small firms with a limited number of persons with sufficient and appropriate experience and authority in the firm, monitoring procedures may need to be performed by some of the same individuals who are responsible for compliance with the firm’s quality control policies and procedures. This includes postissuance review of engagement working papers, reports, and clients’ financial statements by the person with final responsibility for the engagement. To effectively monitor one’s own compliance with the firm’s policies and procedures, it is necessary that an individual be able to critically review his or her own performance, assess his or her own strengths and weaknesses, and maintain an attitude of continual improvement. Changes in conditions and in the environment within the firm (such as obtaining clients in an industry not previously serviced or significantly changing the size of the firm) may indicate the need to have quality control policies and procedures monitored by another qualified individual.

Having an individual inspect his or her own compliance with a quality control system may be less effective than having such compliance inspected by another qualified individual. When one individual inspects his or her own compliance, the firm has a higher risk that noncompliance with policies and procedures will not be detected. Accordingly, a firm with a limited number of persons with sufficient and appropriate experience and authority in the firm may find it beneficial to engage a qualified individual from outside the firm to perform inspection procedures.

Any system of quality control has inherent limitations that can reduce its effectiveness. Deficiencies in individual engagements covered by this section do not, in and of themselves, indicate that the firm’s system of quality control is insufficient to provide it with reasonable assurance that its personnel comply with applicable professional standards. The firm should evaluate the effect of deficiencies noted as a result of the monitoring process and determine whether they require prompt corrective action.

Deficiencies identified during the monitoring process may be
.113 The firm should communicate to relevant engagement partners and other appropriate personnel deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.

.114 The firm’s evaluation of each type of deficiency should result in recommendations for one or more of the following:

a. Taking appropriate remedial action in relation to an individual engagement or member of personnel.

b. The communication of the findings to those responsible for training and professional development.

c. Changes to the quality control policies and procedures.

d. Disciplinary action against those who fail to comply with the policies and procedures of the firm, especially those who do so repeatedly.

.115 When the results of the monitoring procedures indicate that a report may be inappropriate or that procedures were omitted during the performance of the engagement, the firm should determine what further action is appropriate to comply with relevant professional standards and regulatory and legal requirements. The firm may also consider obtaining legal advice.

.116 At least annually, the firm should communicate the results of the monitoring of its quality control system process to relevant engagement partners and other appropriate individuals within the firm, including the firm’s leadership. Such communication should enable the firm and these individuals to take prompt and appropriate action where necessary in accordance with their defined roles and responsibilities and provide a basis for them to rely on the firm’s system of quality control. Information communicated should include the following:

a. A description of the monitoring procedures performed.

b. The conclusions drawn from the monitoring procedures.

c. Where relevant, a description of systemic, repetitive, or other significant deficiencies and of the actions taken to resolve or amend those deficiencies.

.117 The reporting of identified deficiencies to individuals other than the relevant engagement partner need not include an identification of the specific engagements concerned, unless such identification is necessary for the proper discharge of the responsibilities of the individuals other than the engagement partner.

.118 The firm should establish policies and procedures requiring appropriate documentation of monitoring (see paragraph .125). Appropriate documentation relating to monitoring includes:

a. Monitoring procedures, including the procedure for selecting completed engagements to be inspected;

b. A record of the evaluation of:

(i) Adherence to professional standards and regulatory and legal requirements;
(ii) Whether the quality control system has been appropriately designed and effectively imple-
mented; and

(iii) Whether the firm’s quality control policies and procedures have been operating effectively,
so that reports that are issued by the firm or engagement partners are appropriate in the
circumstances; and

c. Identification of the deficiencies noted, an evaluation of their effect, and the basis for determining
whether and what further action is necessary.

The Relationship of Peer Review to Monitoring

.119 A peer review does not substitute for all monitoring procedures. However, since the objective of a
peer review is similar to that of inspection procedures, a firm’s quality control policies and procedures may
provide that a peer review conducted under standards established by the AICPA may substitute for the
inspection of engagement working papers, reports, and clients’ financial statements for some or all
engagements for the period covered by the peer review.

Complaints and Allegations

.120 The firm should establish policies and procedures designed to provide it with reasonable assurance
that it deals appropriately with:

a. Complaints and allegations that the work performed by the firm fails to comply with professional
standards and regulatory and legal requirements; and

b. Allegations of noncompliance with the firm’s system of quality control; and

c. Deficiencies in the design or operation of the firm’s quality control policies and procedures, or
noncompliance with the firm’s system of quality control by an individual or individuals, as
identified during the investigations into complaints and allegations.

.121 As part of this process, the firm should establish clearly defined channels for firm personnel to raise
any concerns in a manner that enables them to come forward without fear of reprisals.

.122 Complaints and allegations of noncompliance with the firm’s system of quality control (which do
not include those that are clearly frivolous) may originate from within or outside the firm. They may be
made by firm personnel, clients, state boards of accountancy, other regulators, or other third parties. They
may be received by engagement team members or other firm personnel.

.123 The firm should require that investigations of such complaints and allegations in accordance with
established policies and procedures be supervised by a person with sufficient and appropriate experience
and authority who is not otherwise involved in the engagement. The firm’s policies and procedures may
require involving legal counsel in the investigation. Small firms and sole practitioners may use the services
of a qualified external person or another firm to carry out the investigation.

.124 The firm should establish policies and procedures requiring documentation of complaints and
allegations, and the responses to them.

Documentation of Operation of Quality Control Policies and Procedures

.125 The firm should establish policies and procedures requiring appropriate documentation to provide
evidence of the operation of each element of its system of quality control.
The form and content of documentation evidencing the operation of each of the elements of the system of quality control is a matter of judgment and depends on a number of factors, including, for example:

- The size of the firm and the number of offices.
- The nature and complexity of the firm’s practice and organization.

For example, large firms may use electronic databases to document matters such as independence confirmations, performance evaluations and the results of monitoring inspections. Smaller firms may use more informal methods such as manual notes, checklists, and forms.

The firm should establish policies and procedures that require retention of documentation for a period of time sufficient to permit those performing monitoring procedures and peer review to evaluate the firm’s compliance with its system of quality control, or for a longer period if required by law or regulation.

Effective Date

The provisions of this section are applicable to a CPA firm’s system of quality control for its accounting and auditing practice as of January 1, 2009.
Appendix B:

Interpretation No. 101-14 of Rule 101

Interpretation No. 101-14, “The effect of alternative practice structures on the applicability of independence rules”

Because of changes in the manner in which members are structuring their practices, the AICPA’s professional ethics executive committee (PEEC) studied various alternatives to “traditional structures” to determine whether additional independence requirements are necessary to ensure the protection of the public interest.

In many “nontraditional structures,” a substantial (the nonattest) portion of a member’s practice is conducted under public or private ownership, and the attest portion of the practice is conducted through a separate firm owned and controlled by the member. All such structures must comply with applicable laws, regulations, and Rule 505, Form of Organization and Name [ET section 505.01]. In complying with laws, regulations, and rule 505 [ET section 505.01], many elements of quality control are required to ensure that the public interest is adequately protected. For example, all services performed by members and persons over whom they have control must comply with standards promulgated by AICPA Council-designated bodies, and, for all other firms providing attest services, enrollment is required in an AICPA-approved practice-monitoring program.

Finally, and importantly, the members are responsible, financially and otherwise, for all the attest work performed. Considering the extent of such measures, PEEC believes that the additional independence rules set forth in this interpretation are sufficient to ensure that attest services can be performed with objectivity and, therefore, the additional rules satisfactorily protect the public interest.

Rule 505 [ET section 505.01] and the following independence rules for an alternative practice structure (APS) are intended to be conceptual and applicable to all structures where the “traditional firm” engaged in attest services is closely aligned with another organization, public or private, that performs other professional services. The following paragraph and the chart below provide an example of a structure in use at the time this interpretation was developed. Many of the references in this interpretation are to the example. PEEC intends that the concepts expressed herein be applied, in spirit and in substance, to variations of the example structure as they develop.

The example APS in this interpretation is one where an existing CPA practice (“Oldfirm”) is sold by its owners to another (possibly public) entity (“PublicCo”). PublicCo has subsidiaries or divisions such as a bank, insurance company or broker-dealer, and it also has one or more professional service subsidiaries or divisions that offer to clients nonattest professional services (e.g., tax, personal financial planning, and management consulting). The owners and employees of Oldfirm become employees of one of PublicCo’s subsidiaries or divisions and may provide those nonattest services. In addition, the owners of Oldfirm form a new CPA firm (“Newfirm”) to provide attest services. CPAs, including the former owners of Oldfirm, own a majority of Newfirm (as to vote and financial interests). Attest services are performed by Newfirm and are supervised by its owners. The arrangement between Newfirm and PublicCo (or one of its subsidiaries or divisions) includes the lease of employees, office space and equipment; the performance of back-office functions such as billing and collections; and advertising. Newfirm pays a negotiated amount for these services.

APS Independence Rules for Covered Members

The term covered member in an APS includes both employed and leased individuals. The firm in such definition would be Newfirm in the example APS. All covered members, including the firm, are subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety. For example, no covered member may have, among other things, a direct financial interest in or a loan to or from an attest client of Newfirm.

Partners of one Newfirm generally would not be considered partners of another Newfirm except in situations where those partners perform services for the other Newfirm or where there are significant shared economic interests between partners of more than one Newfirm. If, for example, partners of Newfirm 1 perform services in Newfirm 2, such owners would be considered to be partners of both Newfirms for purposes of applying the independence rules.

* Terms shown in boldface type upon first usage in this interpretation are defined in ET section 92, Definitions.

AICPA Audit and Accounting Manual

AAM §10,200 App B
APS Independence Rules for Persons and Entities Other Than Covered Members

As stated above, the independence rules normally extend only to those persons and entities included in the definition of covered member. This normally would include only the “traditional firm” (Newfirm in the example APS), those covered members who own or are employed or leased by Newfirm, and entities controlled by one or more of such persons. Because of the close alignment in many APSs between persons and entities included in covered member and other persons and entities, to ensure the protection of the public interest, PEEC believes it appropriate to require restrictions in addition to those required in a traditional firm structure. Those restrictions are divided into two groups:

1. Direct Superiors. Direct Superiors are defined to include those persons so closely associated with a partner or manager who is a covered member, that such persons can directly control the activities of such partner or manager. For this purpose, a person who can directly control is the immediate superior of the partner or manager who has the power to direct the activities of that person so as to be able to directly or indirectly (e.g. through another entity over which the Direct Superior can exercise significant influence\(^1\)) derive a benefit from that person’s activities. Examples would be the person who has day-to-day responsibility for the activities of the partner or manager and is in a position to recommend promotions and compensation levels. This group of persons is, in the view of PEEC, so closely aligned through direct reporting relationships with such persons that their interests would seem to be inseparable. Consequently, persons considered Direct Superiors, and entities within the APS over which such persons can exercise significant influence\(^2\) are subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety.

2. Indirect Superiors and Other PublicCo Entities. Indirect Superiors are those persons who are one or more levels above persons included in Direct Superior. Generally, this would start with persons in an organization structure to whom Direct Superiors report and go up the line from there. PEEC believes that certain restrictions must be placed on Indirect Superiors, but also believes that such persons are sufficiently removed from partners and managers who are covered persons to permit a somewhat less restrictive standard. Indirect Superiors are not connected with partners and managers who are covered members through direct reporting relationships; there always is a level in between. The PEEC also believes that, for purposes of the following, the definition of Indirect Superior also includes the immediate family of the Indirect Superior.

PEEC carefully considered the risk that an Indirect Superior, through a Direct Superior, might attempt to influence the decisions made during the engagement for a Newfirm attest client. PEEC believes that this risk is reduced to a sufficiently low level by prohibiting certain relationships between Indirect Superiors and Newfirm attest clients and by applying a materiality concept with respect to financial relationships. If the financial relationship is not material to the Indirect Superior, PEEC believes that he or she would not be sufficiently financially motivated to attempt such influence particularly with sufficient effort to overcome the presumed integrity, objectivity and strength of character of individuals involved in the engagement.

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\(^1\) For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in Accounting Principles Board Opinion No. 18 [AC section 82] and its interpretations to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive.

\(^2\) For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in Accounting Principles Board Opinion No. 18 [AC section 82] and its interpretations to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive.
Similar standards also are appropriate for Other PublicCo Entities. These entities are defined to include PublicCo and all entities consolidated in the PublicCo financial statements that are not subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety.

The rules for Indirect Superiors and Other PublicCo Entities are as follows:

A. Indirect Superiors and Other PublicCo Entities may not have a relationship contemplated by interpretation 101-1.A [ET section 101.02] (e.g., investments, loans, etc.) with an attest client of Newfirm that is material. In making the test for materiality for financial relationships of an Indirect Superior, all the financial relationships with an attest client held by such person should be aggregated and, to determine materiality, assessed in relation to the person’s net worth. In making the materiality test for financial relationships of Other PublicCo Entities, all the financial relationships with an attest client held by such entities should be aggregated and, to determine materiality, assessed in relation to the consolidated financial statements of PublicCo. In addition, any Other PublicCo Entity over which an Indirect Superior has direct responsibility cannot have a financial relationship with an attest client that is material in relation to the Other PublicCo Entity’s financial statements.

B. Further, financial relationships of Indirect Superiors or Other PublicCo Entities should not allow such persons or entities to exercise significant influence over the attest client. In making the test for significant influence, financial relationships of all Indirect Superiors and Other PublicCo Entities should be aggregated.

C. Neither Other PublicCo Entities nor any of their employees may be connected with an attest client of Newfirm as a promoter, underwriter, voting trustee, director or officer.

D. Except as noted in C above, Indirect Superiors and Other PublicCo Entities may provide services to an attest client of Newfirm that would impair independence if performed by Newfirm. For example, trustee and asset custodial services in the ordinary course of business by a bank subsidiary of PublicCo would be acceptable as long as the bank was not subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety.

Other Matters

1. An example, using the chart below, of the application of the concept of Direct and Indirect Superiors would be as follows: The chief executive of the local office of the Professional Services Subsidiary (PSS), where the partners of Newfirm are employed, would be a Direct Superior. The chief executive of PSS itself would be an Indirect Superior, and there may be Indirect Superiors in between such as a regional chief executive of all PSS offices within a geographic area.

2. PEEC has concluded that Newfirm (and its partners and employees) may not perform an attest engagement for PublicCo or any of its subsidiaries or divisions.

3. PEEC has concluded that independence would be considered to be impaired with respect to an attest client of Newfirm if such attest client holds an investment in PublicCo that is material to the attest client or allows the attest client to exercise significant influence over PublicCo.

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3 For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in Accounting Principles Board Opinion No. 18 [AC section 182] and its interpretations to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive.

4 For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in Accounting Principles Board Opinion No. 18 [AC section 182] and its interpretations to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive.
4. When making referrals of services between Newfirm and any of the entities within PublicCo, a member should consider the provisions of Interpretation 102-2, *Conflicts of Interest* [ET section 102.03].

**Alternative Practice Structure (APS) Model**

[Diagram not transcribed]

[The next page is 10,261.]
AAM Section 10,250

Statement on Quality Control Standards

Statements on Quality Control Standards (SQCSs) are issued by the Auditing Standards Board. Firms that are enrolled in an AICPA approved practice-monitoring program are obligated to adhere to quality control standards established by the AICPA.

Statement on Quality Control Standards No. 7, A Firm’s System of Quality Control (QC section 10)

Supersedes SQCSs Nos. 2–6. SQCS No. 1 was previously superseded by SQCS No. 2.

Effective date: Applicable to a CPA firm’s system of quality control for its accounting and auditing practice as of January 1, 2009.

[Refer to AAM section 10,200 appendix A for reprint.]

[The next page is 10,281.]
AAM Section 10,280

Interpretation No. 101-14 of Rule 101, Independence


[Refer to AAM section 10,200 appendix B for reprint.]

[The next page is 10,301.]
AAM Section 10,300

Sample Quality Control Forms

.01 The following are sample documents and forms that practitioners may find useful.
.02 Independence and Representation Checklist for Other Auditors

Office ______________________
Firm name _____________________

In order to determine that your firm is in compliance with the independence standards, regulations, interpretations and rulings of the AICPA, the [name of State] CPA Society, the [name of State] Board of Accountancy, and [name of State] statutes the following must be completed by _____ [date] and returned to _____ as noted. If there are any questions you have related to the completion of the form, or if there is a matter that has come to your attention which may impair your firm’s independence, please contact [name of Partner] to resolve the problem.

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. We are aware that [Name of primary auditor] has been engaged to audit the financial statements of [Name of parent] as of [Date] and for the [period, for example, year] then ended.</td>
<td>_____</td>
<td>_____</td>
</tr>
<tr>
<td>2. We are aware that [Name of primary auditor] plans to rely on our audit of the financial statements of [Name of subsidiary or component] as of [Date] and for the [period, for example, year] then ended.</td>
<td>_____</td>
<td>_____</td>
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<tr>
<td>3. [We are aware that the primary auditor will refer to our report in their report.]</td>
<td>_____</td>
<td>_____</td>
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<tr>
<td>4. We are independent with respect to [Name of both the parent and subsidiary or component.]</td>
<td>_____</td>
<td>_____</td>
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</tbody>
</table>

______________________________ _____________________ _________
Partner of other audit firm Date

Reviewed by:

______________________________
Partner of primary audit firm
## .03 Scheduling Request

<table>
<thead>
<tr>
<th>Personnel Requested</th>
<th>Experience Level</th>
<th>Interim From</th>
<th>Thru</th>
<th>Hours</th>
<th>Year End From</th>
<th>Thru</th>
<th>Hours</th>
<th>Total Hours</th>
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</table>

Audited? Yes____ No____
SEC? Yes____ No____
Reviewed? Yes____ No____
Compiled? Yes____ No____
Attestation? Yes____ No____

Industry__________________________

Can dates be adjusted? Yes ____ No____
Can personnel be changed? Yes ____ No____
Comments ____________________________________________________________________________________
______________________________________________________________________________________________
______________________________________________________________________________________________

Estimated total hours:
Partner__________________________
Manager________________________
Staff___________________________

Can dates be adjusted? Yes ____ No____
Can personnel be changed? Yes ____ No____

Requested by____________________Date _______________ Scheduled ____________Date _______

Assignment
Manager
### History of Staff Assignments

<table>
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<tr>
<th>NAME</th>
<th>ASSIGNMENT DESCRIPTION</th>
<th>CLIENT/LOCATION</th>
<th>DATES</th>
<th>RESPONSIBILITY LEVEL</th>
<th>TOTAL HOURS</th>
<th>INDUSTRY</th>
<th>SEC</th>
<th>AUDIT AREAS PERFORMED</th>
<th>REPORTED TO</th>
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### Client History of Personnel Assigned

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<th>LOCATION</th>
<th>YEAR ENDING</th>
<th>AUDITED?</th>
<th>SEC?</th>
<th>FISCAL YEAR</th>
<th>HOURS</th>
<th>ENTER NAMES AND CHARGEABLE HOURS FOR THE YEAR</th>
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</table>
## Scheduling Master Plan

### MONTH OF ______

<table>
<thead>
<tr>
<th>Staff member</th>
<th>Carry forward</th>
<th>Month assignments</th>
<th>Nonworking hours</th>
<th>Nonrecurring assignments</th>
<th>Hours for month</th>
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## Consultation Log

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<tr>
<th>DATE</th>
<th>MODE OF COMMUNICATION</th>
<th>CLIENT</th>
<th>OFFICE</th>
<th>REQUEST</th>
<th>RESPONSE</th>
<th>REQUIRED YES/NO</th>
<th>DATE REC'D</th>
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AICPA Audit and Accounting Manual

AAM §10,300.07
.08 Consultation Worksheet

DATE

CLIENT NAME

LOCATION

ENGAGEMENT (TYPE)

SUBJECT (QUESTION)

CONSULTANT’S RESPONSE: (Cite professional literature discussed and conclusion of consultant)

FINAL RESOLUTION

Senior/Manager

Date

Partner

Date
### PRE-EMPLOYMENT APPLICATION

<table>
<thead>
<tr>
<th>NAME</th>
<th>DATE</th>
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</thead>
<tbody>
<tr>
<td>ADDRESS</td>
<td></td>
</tr>
<tr>
<td>TELEPHONE NUMBER</td>
<td>SOCIAL SECURITY NUMBER</td>
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</tbody>
</table>

### POSITION APPLIED FOR

<table>
<thead>
<tr>
<th>FIRST CHOICE</th>
<th>SECOND CHOICE</th>
<th>MINIMUM SALARY REQUIRED: $</th>
</tr>
</thead>
<tbody>
<tr>
<td>☐ Full Time</td>
<td>☐ Permanent Part Time</td>
<td>☐ Temporary</td>
</tr>
</tbody>
</table>

**REFERRED BY**

- ☐ Newspaper ad
- ☐ Agency
- ☐ Friend
- ☐ Other

**NAME**

**NAME**

### EDUCATIONAL BACKGROUND — ☐ See Below ☐ See Attached Resume

<table>
<thead>
<tr>
<th>NAME &amp; LOCATION OF SCHOOL</th>
<th>MAJOR COURSE</th>
<th>YEARS ATTENDED FROM</th>
<th>TO</th>
<th>YEAR GRAD.</th>
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<tbody>
<tr>
<td>Elementary</td>
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<td>High or Vocational</td>
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<td>Business or Technical</td>
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<td>College</td>
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<td>Graduate</td>
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### ADDITIONAL SKILLS OR MACHINE KNOWLEDGE — ☐ See Below ☐ See Attached Resume

*Note: See the AICPA Management of an Accounting Practice Handbook for an alternative.*
### EMPLOYMENT HISTORY

<table>
<thead>
<tr>
<th>FROM</th>
<th>TO</th>
<th>EMPLOYER’S NAME</th>
<th>EMPLOYER’S ADDRESS</th>
<th>POSITION OR TITLE</th>
<th>SUPERVISION</th>
<th>REASON FOR LEAVING</th>
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**USE THIS SPACE TO ACCOUNT FOR PERIODS NOT WORKED**

**ADDITIONAL INFORMATION HELPFUL IN CONSIDERING EMPLOYMENT**

---

### AGREEMENT

“I certify that the information given by me in this application is true in all respects, and I agree that if employed and it is found to be false in any way, that I may be subject to dismissal without notice, if and when discovered. I authorize the use of any information in this application to enable _______ to verify my statements, and I authorize _______ past employers, doctors, all references and any other persons to answer all questions asked by _______ concerning my ability, character, reputation, and previous employment record. I release all such persons from any liability or damages on account of having furnished such information. I further agree, if employed, that (i) I am to work faithfully and diligently, to be careful and avoid accident, to come to work promptly, and I am not to be absent for any reason without prior notice to my supervisor, (ii) upon termination of employment, _______ may answer all questions asked of any prospective employer concerning my ability, character, reputation and employment record. I agree to submit to a physical examination whenever requested by _______ and, if employed, I agree to abide by all present and subsequently issued personnel policies and rules of _______.

APPLICANT’S SIGNATURE: ___________________________ DATE: ___________________________”
.10 Interview Report

<table>
<thead>
<tr>
<th>DAY</th>
<th>DATE</th>
<th>TIME</th>
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</table>

<table>
<thead>
<tr>
<th>NAME OF APPLICANT</th>
<th>POSITION APPLIED FOR</th>
</tr>
</thead>
</table>

COMMENTS BY INTERVIEWER:

RECOMMENDED ACTION:

INTERVIEWED BY: ___________________ TITLE: ___________________

PLEASE RETURN TO HUMAN RESOURCES AS SOON AS POSSIBLE

Note: See the AICPA Management of an Accounting Practice Handbook for an alternative.
## Record of Professional Development

Name__________________________________________________  Employee No.____________________

### Out-of-Office Courses:

<table>
<thead>
<tr>
<th>Sponsor</th>
<th>Course description</th>
<th>No. of hours</th>
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</tbody>
</table>

### In-House Programs:

<table>
<thead>
<tr>
<th>Instructor</th>
<th>Course description</th>
<th>No. of hours</th>
<th>Date completed</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td></td>
<td></td>
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<tr>
<td>2.</td>
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<td>9.</td>
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<tr>
<td>10.</td>
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</table>
## 20XX Professional Development

### Summary (in hours)

<table>
<thead>
<tr>
<th>In-house presentations</th>
<th>Developed in-house</th>
<th>Purchased programs</th>
<th>Outside courses</th>
<th>Total</th>
</tr>
</thead>
</table>

#### Partners/Owners

<table>
<thead>
<tr>
<th>1.</th>
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<tbody>
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<tr>
<td>3.</td>
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#### Professional staff

<table>
<thead>
<tr>
<th>1.</th>
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</thead>
<tbody>
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<td>8.</td>
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</table>

#### Paraprofessionals

<table>
<thead>
<tr>
<th>1.</th>
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</thead>
<tbody>
<tr>
<td>2.</td>
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<tr>
<td>4.</td>
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</table>
### 20XX Professional Development

**Summary (in dollars)**

<table>
<thead>
<tr>
<th>Partners/Owners</th>
<th>Purchased programs for in-house use</th>
<th>Outside courses</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>$_________________________</td>
<td>$_________</td>
<td>$_________</td>
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<tr>
<td>2.</td>
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<td>___________</td>
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<tr>
<td>3.</td>
<td>_____________________________</td>
<td>___________</td>
<td>___________</td>
</tr>
</tbody>
</table>

**Professional staff**

| 1.              | _____________________________ | ___________ | ___________ |
| 2.              | _____________________________ | ___________ | ___________ |
| 3.              | _____________________________ | ___________ | ___________ |
| 4.              | _____________________________ | ___________ | ___________ |
| 5.              | _____________________________ | ___________ | ___________ |
| 6.              | _____________________________ | ___________ | ___________ |
| 7.              | _____________________________ | ___________ | ___________ |
| 8.              | _____________________________ | ___________ | ___________ |

**Paraprofessionals**

| 1.              | _____________________________ | ___________ | ___________ |
| 2.              | _____________________________ | ___________ | ___________ |
| 3.              | _____________________________ | ___________ | ___________ |
| 4.              | _____________________________ | ___________ | ___________ |
### .14 Performance Evaluation

*To be completed after each engagement of 40 hours or more.*

<table>
<thead>
<tr>
<th>Name ______________________________</th>
<th>Classification ____________________________</th>
</tr>
</thead>
<tbody>
<tr>
<td>Client ___________________________</td>
<td>From ____________ To ____________</td>
</tr>
<tr>
<td>Describe work assigned: ____________________________________________________</td>
<td></td>
</tr>
</tbody>
</table>

In your opinion based on the staff member’s classification, should this assignment be considered:

- Demanding □
- Routine □

This individual is □ is not □ ready for increased responsibility. Explain ____________________________________________

#### Rating:

Enter comments which describe the staff member’s performance on this engagement. Rate the staff member on each of the items below as Outstanding (O), Very High (VH), Good (G), Below Normal (BN), or Not Applicable (NA).

[Support each caption with specific incidents or remarks.]

**Technical Knowledge:** Did the staff member possess adequate knowledge to function effectively at the level assigned? Did this knowledge encompass accounting principles, auditing standards, and tax accounting? Has the staff member kept current on recent developments and new pronouncements on professional practice matters as they affected this engagement?

<table>
<thead>
<tr>
<th>Rating:</th>
<th>O VH G BN NA</th>
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<tbody>
<tr>
<td>□ □ □ □ □</td>
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</tbody>
</table>

**Analytical Ability and Judgment:** How well did the staff member recognize problems, develop relevant facts, formulate alternative solutions, and decide on appropriate conclusions? Did the staff member distinguish between material and immaterial items? Was the staff member practical in adapting theory and experience to the individual circumstances of this client?

<table>
<thead>
<tr>
<th>Rating:</th>
<th>O VH G BN NA</th>
</tr>
</thead>
<tbody>
<tr>
<td>□ □ □ □ □</td>
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</tr>
</tbody>
</table>

**Written and Oral Expression:** Evaluate the effectiveness of the staff member’s letters, memoranda, and other forms of written communication. In conversation, did the staff member communicate intentions effectively? Were instructions understood the first time? Did the staff member sell ideas, obtain acceptance and action?

<table>
<thead>
<tr>
<th>Rating:</th>
<th>O VH G BN NA</th>
</tr>
</thead>
<tbody>
<tr>
<td>□ □ □ □ □</td>
<td></td>
</tr>
</tbody>
</table>

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AICPA Audit and Accounting Manual

AAM §10,300.14
Performance: Can you depend on the staff member for sustained, productive work? Were assignments organized and completed accurately in a reasonable amount of time? Did the staff member readily assume responsibility? Did the staff member meet time estimates and document work papers properly?
Rating: □ □ □ □ □

Development of Personnel: In assigning work, did the in-charge member make the most effective use of available talent in terms of getting the work done and in terms of developing staff members performing the work? Did the in-charge staff member tend to make assignments which were either too easy or too hard for his subordinates? Was the staff member readily accepted as a leader? Was the staff member effective in on-the-job coaching?
Rating: □ □ □ □ □

Client Relations: How well did the staff member relate to this client and gain his acceptance? How well did the staff member recognize and take advantage of practice development opportunities, through extension of services to this client?
Rating: □ □ □ □ □

Attitude: Did the staff member demonstrate a positive and professional approach to the assignment? Was this demonstrated by sustained effort in completing work? Was the assignment undertaken with enthusiasm and zest? Did the staff member respond in a positive way to suggestions and guidance from superiors? To what degree did the staff member make personal sacrifices to meet client requirements? Was the staff member a helpful member of the team? Did the staff member go out of his way to help an associate?
Rating: □ □ □ □ □

Personal Characteristics: Did the staff member possess self-confidence and was this confidence projected in an acceptable way? Were positive impressions created with this client and with associates? Did the staff member have a keen sense of what to do or say (tact)? Were clothes appropriate to professional work? Was the staff member well groomed?
Rating: □ □ □ □ □

Note: See the AICPA MAP Handbook for alternatives.
Strong points which were evident: ______________________________________________________________
____________________________________________________________________________________________
____________________________________________________________________________________________
____________________________________________________________________________________________
____________________________________________________________________________________________

Recommendations for improvement:____________________________________________________________
____________________________________________________________________________________________
____________________________________________________________________________________________
____________________________________________________________________________________________
____________________________________________________________________________________________

Comments of Staff Member Being Evaluated: ____________________________________________________
____________________________________________________________________________________________
____________________________________________________________________________________________
____________________________________________________________________________________________
____________________________________________________________________________________________

Signatures:
Evaluated staff member ______________________________________________________ Date ___________
Evaluator ________________________________________________ Title ________________ Date ___________
Engagement manager ________________________________________________________ Date ___________
Partner _________________________________________________________________ Date ___________
## JOB EVALUATION REPORT

[For Assignments of Thirty (30) Hours or More]

| Name _______________________________________________________________ |
| Location ____________________________________________________________ |
| Engagement ________________________________________________________ |
| Assistant _____________________________ In-Charge ______________________ |

### A. PERFORMANCE ON THE JOB

1. **Technical Ability Demonstrated**
   - a) The purpose of the audit procedures planned was understood
   - b) Materiality was neither underestimated nor overestimated
   - c) Accounting theory and current releases of the profession were applied correctly
   - d) Federal and state income tax regulations were applied correctly

2. **Working Paper Evidence**
   - a) Documentation of work performance, including adequate indexing and cross referencing
   - b) Sound explanations and conclusions
   - c) Use of standard work papers
   - d) Legibility
   - e) Accuracy — absence of mathematical errors

3. **Completing This Job**
   - a) Meeting planned time estimates
   - b) Completing reports and tax returns
   - c) Following up the reviewer’s comments and making the necessary changes

4. **Client Reaction on This Job**
   - a) Getting along with the client’s employees
   - b) Interest in the client’s business

### B. ENGAGEMENT ADMINISTRATION — (For In-Charge Accountants Only)

1. **Effectiveness of Proper Planning**
   - a) Extent that the scope of the work related to internal control
   - b) Developing the work program

2. **Utilizing Staff Effectively and Efficiently**
   - a) Advance planning to minimize crises
   - b) Efficient use of staff on the job
   - c) On-the-job training of assistants

3. **Meeting Deadlines**
   - a) Completing the engagement in the planned time
   - b) Delivering completed pencil copies of the report and tax returns to the supervisor as agreed

4. **The Product**
   - a) Quality of report preparation, including adequate and informative disclosures
   - b) Quality of the management advice recommendations

5. **Practice Management**
   - a) Extending service
   - b) Ease of collecting for services performed
Knowledge and Skill Form
(and Profile of Management Role Performance)

<table>
<thead>
<tr>
<th>Staff member evaluated</th>
<th>Date</th>
</tr>
</thead>
</table>

Evaluator

(Circle at least two but not more than four in each section and indicate the effectiveness of each trait.)

<table>
<thead>
<tr>
<th>Planner</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Careful</td>
<td>Sloppy</td>
</tr>
<tr>
<td>Imaginative</td>
<td>Foresighted</td>
</tr>
<tr>
<td>Routine</td>
<td>Erratic</td>
</tr>
<tr>
<td>Constant</td>
<td>Cautious</td>
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</table>

<table>
<thead>
<tr>
<th>Problem solver</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Analytical</td>
<td>Consistent</td>
</tr>
<tr>
<td>Critical</td>
<td>Faulty</td>
</tr>
<tr>
<td>Hasty</td>
<td>Creative</td>
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<tr>
<td>Slow</td>
<td>Quick</td>
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<table>
<thead>
<tr>
<th>Communicator</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Warm</td>
<td>Sloppy</td>
</tr>
<tr>
<td>Inhibited</td>
<td>Weak</td>
</tr>
<tr>
<td>Thorough</td>
<td>Receptive</td>
</tr>
<tr>
<td>Expressive</td>
<td>Efficient</td>
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<table>
<thead>
<tr>
<th>Leader</th>
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</thead>
<tbody>
<tr>
<td>Dominating</td>
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<tr>
<td>Weak</td>
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<tr>
<td>Loose</td>
<td>Amiable</td>
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<tr>
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<tbody>
<tr>
<td>Decisive</td>
<td>Lone</td>
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<tr>
<td>Slow</td>
<td>Avoider</td>
</tr>
<tr>
<td>Quick</td>
<td>Seldom</td>
</tr>
<tr>
<td>Frequent</td>
<td>Rash</td>
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<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Systematic</td>
<td>Unprepared</td>
</tr>
<tr>
<td>Patient</td>
<td>Efficient</td>
</tr>
<tr>
<td>Sloppy</td>
<td>Diligent</td>
</tr>
<tr>
<td>Off-on</td>
<td>Slow</td>
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<table>
<thead>
<tr>
<th>Team member</th>
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<tbody>
<tr>
<td>Cooperative</td>
<td>Unreliable</td>
</tr>
<tr>
<td>Influential</td>
<td>Divisive</td>
</tr>
<tr>
<td>Conformist</td>
<td>Reliable</td>
</tr>
<tr>
<td>Forceful</td>
<td>Reluctant</td>
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<table>
<thead>
<tr>
<th>Innovator</th>
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<tbody>
<tr>
<td>Original</td>
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<tr>
<td>Constant</td>
<td>Disruptive</td>
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<table>
<thead>
<tr>
<th>Job expertise</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Amateur</td>
<td>Improving</td>
</tr>
<tr>
<td>Obsolete</td>
<td>Mediocre</td>
</tr>
<tr>
<td>Masterful</td>
<td>Balanced</td>
</tr>
<tr>
<td>Versatile</td>
<td>Up-to-date</td>
</tr>
</tbody>
</table>

(Complete Annually)
## Employee Annual Performance Appraisal

### Time Period Involved

<table>
<thead>
<tr>
<th>From</th>
<th>To</th>
</tr>
</thead>
</table>

### EXEMPT  

### NON-EXEMPT

### Name  

### Position Title  

### Number

### Hire Date  

### Present Position Date

### Days Absent From: __________________ To: _____

### Charged To  

### Sick Time: __________________

### Disability: __________________

### Strengths

### Development Needs

### Suggested Plan for Performance Improvement

### Summary

### Overall Rating on Having Met Job Requirements

<table>
<thead>
<tr>
<th>Non-Exempt - Circle One</th>
<th>Exempt - Circle One</th>
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<tbody>
<tr>
<td>1 = Did Not Meet Job Requirements</td>
<td>1 = Did Not Meet Job Requirements</td>
</tr>
<tr>
<td>2 = Met All</td>
<td>2 = Met Most</td>
</tr>
<tr>
<td>3 = Exceeded</td>
<td>3 = Met All</td>
</tr>
<tr>
<td></td>
<td>4 = Exceeded</td>
</tr>
<tr>
<td></td>
<td>5 = Far Exceeded</td>
</tr>
</tbody>
</table>
Review the following questions before answering them, using the following criteria:

- A *yes* answer should be considered for possible mention as a “strength.” If so, refer to it on the first page of this evaluation.
- A *no* answer should be considered for possible mention as a “development need.” If so, refer to it on the first page of this evaluation.

All answers should be considered in arriving at an overall rating on having met job requirements.

<table>
<thead>
<tr>
<th>CHECK AS APPROPRIATE</th>
<th>Strength</th>
<th>Yes</th>
<th>N/A</th>
<th>No</th>
<th>Development Need</th>
</tr>
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**Quality of Work**

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</thead>
<tbody>
<tr>
<td>Is work accurate, neat, and clearly presented?</td>
<td>( ) ( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Carefully planned, well organized, and thorough?</td>
<td>( ) ( )</td>
<td>( )</td>
<td>( )</td>
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</table>

**Productivity**

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<tbody>
<tr>
<td>Is a good level of production maintained?</td>
<td>( ) ( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Are deadlines met?</td>
<td>( ) ( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Are pressure situations handled effectively?</td>
<td>( ) ( )</td>
<td>( )</td>
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</table>

**Knowledge of Job**

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</thead>
<tbody>
<tr>
<td>Does the individual know where to get information?</td>
<td>( ) ( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Is the individual used as a source of information by others?</td>
<td>( ) ( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
</tbody>
</table>

**Communication**

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</thead>
<tbody>
<tr>
<td>Does the individual ask for clarification when necessary?</td>
<td>( ) ( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Does the individual respond to others in a manner that indicates understanding?</td>
<td>( ) ( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Are ideas expressed so that others are able to understand them?</td>
<td>( ) ( )</td>
<td>( )</td>
<td>( )</td>
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</tbody>
</table>

**Human Relations**

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</thead>
<tbody>
<tr>
<td>Does the individual cooperate with others to get the job done?</td>
<td>( ) ( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Does the individual demonstrate tact and courtesy in dealing with others?</td>
<td>( ) ( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Does the individual maintain a good working relationship with all others?</td>
<td>( ) ( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Are questions and requests dealt with in a helpful manner?</td>
<td>( ) ( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
</tbody>
</table>

**Need for Supervision**

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<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Can the individual be relied upon to get work done without close supervision?</td>
<td>( ) ( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Does the individual take the initiative when appropriate?</td>
<td>( ) ( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
</tbody>
</table>

**Problem Solving**

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<table>
<thead>
<tr>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Does the individual collect the data needed to solve problems?</td>
<td>( ) ( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Are problems solved quickly?</td>
<td>( ) ( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
<td>( )</td>
</tr>
</tbody>
</table>

(continued)
<table>
<thead>
<tr>
<th>Problem Solving—cont’d</th>
<th>CHECK AS APPROPRIATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Are solutions reasonable and accurate?</td>
<td>Strength Yes N/A No</td>
</tr>
<tr>
<td>Does the individual know when to ask for advice and whom to ask?</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Does the individual seek out methods to do work more efficiently?</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Are alternate solutions generated when appropriate?</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Work Habits</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Does the individual comply with the AICPA’s established work hours?</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Does the individual provide proper notification when absent from work?</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Personal Development</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Does the individual try to expand on required knowledge and skills?</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Does the individual readily grasp and master the new job requirements?</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Does the individual show ambition by building on strengths and working on deficiencies?</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Is the individual a good candidate for promotion?</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Is the individual ready for promotion at this time?</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Supervisory Capabilities</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Does the individual demonstrate the ability to direct and be responsible for the performance of others?</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Does the individual effectively evaluate and develop subordinates?</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Are subordinates properly motivated?</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Are subordinates given reasonable goals and aided in meeting them?</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Does the individual comply with administrative and policy guidelines of _________?</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Is good judgment exercised in observing budget constraints?</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Does the individual maintain adequate discipline in regard to subordinates attendance and punctuality?</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>Does the individual provide a good example for peers and subordinates to follow?</td>
<td>( ) ( ) ( ) ( ) ( )</td>
</tr>
</tbody>
</table>
I acknowledge that: (1) I have reviewed and discussed this performance appraisal with the preparer. My signature means that I have been advised of my performance evaluation but does not necessarily imply that I agree with it; (2) I have received a copy of the goals/duties that will be used to evaluate my performance during the coming year; and (3) I have reviewed my job description and do □ do not □ feel it should be revised. My signature and the date I discussed this with the preparer appears below.

<table>
<thead>
<tr>
<th>Employee</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Evaluator/Title</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>
.18 Client/Engagement Acceptance and Continuation Checklist

Note: Acceptance of a new client normally is of critical importance to a small firm. Depending on the type of industry and the services to be provided, accepting a new client can affect nearly all aspects of a firm’s quality control system: Are the firm’s library and practice aids adequate? Do personnel have appropriate CPE? Does the firm need an outside consultant? The best time to document the acceptance decision is when a new audit or attestation client or engagement is signed, using a form such as the one below.

Name of prospective client: ____________________________________________________________________
Address and Phone No.: _____________________________________________________________________
__________________________________________________________________________________________
Name and title of contact at prospective client: ________________________________________________
__________________________________________________________________________________________
Form completed by: ___________________________________________ Date: ______________

Instructions
This form provides for information necessary to assess whether to accept a prospective client. The information should be obtained from discussions with the prospective client’s management, bankers, attorneys, credit services, and if applicable current or former independent CPA, from reviewing the client’s financial statements, regulatory agency reports, credit reports, and tax returns, and from other sources such as industry or accounting journals, etc. As much information as possible should be obtained before visiting the potential client. Depending on the type of engagement involved, some information requested on this form may not be applicable, or additional information may be necessary and should be attached.

Services and Reports Required

1. Describe the service and reports requested. _________________________________________________
   __________________________________________________________________________________________

2. Describe the reason the service is needed, including any regulatory requirements or third parties for which the service or report is intended. ______________________________________________________________________
   __________________________________________________________________________________________

3. What is the required completion date? ______________________________________________________
   __________________________________________________________________________________________

4. Describe any other services not requested for which there appears to be a need. __________________
   __________________________________________________________________________________________

5. What is the preliminary estimate of hours to complete the engagement? _________________________
   __________________________________________________________________________________________

6. Has the client imposed any restrictions on the scope of the engagement that might preclude expression of an unqualified report? ____________________________________________
   __________________________________________________________________________________________

7. Do we have the necessary expertise and staff to perform the engagement? (If not, how will we overcome this problem?) ________________________________
   __________________________________________________________________________________________

1 Certain items in this checklist have been reprinted from the Journal of Accountancy, Copyright © 1997 by AICPA.
Industry Practices and Conditions

8. In what industry does the company operate?_________________________________________________
   ____________________________________________________________________________________

9. Describe any specialized tax or accounting practices applicable to the industry._________________
   ____________________________________________________________________________________
   ____________________________________________________________________________________
   ____________________________________________________________________________________

10. Describe any economic, technological or competitive conditions or other recent developments in the
    industry that may affect the company’s operations._________________________________________
    ____________________________________________________________________________________
    ____________________________________________________________________________________
    ____________________________________________________________________________________

11. Describe any special regulatory requirements applicable to the industry.______________________
    ____________________________________________________________________________________
    ____________________________________________________________________________________
    ____________________________________________________________________________________

12. Is the company in the development stage?_________________________________________________
    ____________________________________________________________________________________
    ____________________________________________________________________________________
    ____________________________________________________________________________________

Organization and Personnel

13. Company’s Legal Name: ______________________________________ Fiscal Year End: _____________
    ____________________________________________________________________________________

14. Type of legal entity (Corporation, S Corporation, partnership, proprietorship, etc.): ____________
    ____________________________________________________________________________________

15. List the major stockholders (partners or owners) of the company and their percentage of ownership. If
    applicable, obtain and attach a copy of the company’s organization chart.
    Name and (if applicable) Title % Ownership
    ____________________________________________________________________________________
    ____________________________________________________________________________________
    ____________________________________________________________________________________
    ____________________________________________________________________________________

16. List the principal members of management.
    Name and Title Stated Qualifications (education, training, and experience)
    ____________________________________________________________________________________
    ____________________________________________________________________________________
    ____________________________________________________________________________________
    ____________________________________________________________________________________

17. Briefly describe any existing or contemplated employee bonus arrangement (individual, title, method
    of computation), stock option, or pension (profit sharing) plans that may affect the engagement.
    ____________________________________________________________________________________
    ____________________________________________________________________________________
    ____________________________________________________________________________________

18. List each location maintained by the company (including foreign locations, if any), the nature of the
    activity performed at each, and the approximate number of employees at each, i.e., plant, sales office,
    executive offices, etc.
    Location Activity No. of Employees
    ____________________________________________________________________________________
    ____________________________________________________________________________________
    ____________________________________________________________________________________
19. Inquire about possible transactions with related parties that may affect the engagement.

<table>
<thead>
<tr>
<th>Name of Related Party</th>
<th>Relationship</th>
<th>Type of Transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</tbody>
</table>

Operations

20. Describe the nature of the company’s major assets and liabilities.

________________________________________________________________________________________
________________________________________________________________________________________
________________________________________________________________________________________

21. What are the company’s sources of revenue and marketing methods? Describe major products, customers, etc.).

________________________________________________________________________________________
________________________________________________________________________________________
________________________________________________________________________________________

22. If the company is economically dependent on a major customer, name the customer and approximate percentage of total revenue generated by this customer.

________________________________________________________________________________________
________________________________________________________________________________________

23. Describe the components of cost of goods sold and the company’s production process.

________________________________________________________________________________________
________________________________________________________________________________________

24. What are the major expenses of the company other than cost of goods sold?

________________________________________________________________________________________
________________________________________________________________________________________

25. Describe the company’s compensation methods, i.e., salary, hourly wage, commissions, piece work, union scale, etc.

________________________________________________________________________________________
________________________________________________________________________________________

26. What are the company’s major sources of financing, i.e., working capital loans, long term debt, leasing, equity, etc. Describe restrictive covenants on any loan agreements.

________________________________________________________________________________________
________________________________________________________________________________________

27. Is management sufficiently knowledgeable about its activities and financial condition?

________________________________________________________________________________________
________________________________________________________________________________________

28. Does it appear that the entity’s activities or resources are heavily concentrated in one or a few high-risk areas?

________________________________________________________________________________________
________________________________________________________________________________________
Accounting

29. Does the company maintain the following items? [Attach description, if appropriate.]
   a. Accounting manual? 
   b. Budget? 
   c. Cost accounting system? 
   d. Information technology? (indicate type of equipment and software) 
   e. Written credit policy? 

30. Briefly describe the accounting system and accounting responsibilities.

<table>
<thead>
<tr>
<th>Description of Accounting Record</th>
<th>Name of Person Who is Responsible</th>
<th>Information Technology</th>
<th>Manual</th>
<th>N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Ledger</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subsidiary Ledgers:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loans payable</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Perpetual inventory</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Physical inventory summarization</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Journals:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash receipts</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash disbursements</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales/purchase/voucher</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payroll</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General journal entries</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial Reporting</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>[Indicate basis of accounting]:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annual financial statements</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Monthly financial statements</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Management reports</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank reconciliations</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

31. Describe the company’s completeness procedures and methods to insure that accounting transactions enter into the accounting system, i.e., that all shipments or services are invoiced, that all cash sales are recorded, and that all disbursements are recorded.

32. Describe any unusual features of the accounting system.
33. Are sufficient records available to perform the engagement?

________________________________________________________________________________________

________________________________________________________________________________________

34. Is management sufficiently knowledgeable about applicable accounting principles?

________________________________________________________________________________________

________________________________________________________________________________________

35. Does management understand accounting matters adequately to assume responsibility for proper valuation, presentation, and disclosure?

________________________________________________________________________________________

________________________________________________________________________________________

Tax Matters

36. Who prepares the tax returns?

________________________________________________________________________________________

37. Describe major differences between book and tax income, unusual tax elections, carry forwards or IRS examinations in process. If possible, review copies of the most recent 3 years of tax returns and attach them to this form.

________________________________________________________________________________________

________________________________________________________________________________________

Other Matters

38. Describe any significant problems that could affect the engagement, such as litigation or other contingencies, unusual agreements, and plans to acquire or dispose of significant assets, merge with another entity, enter a new area of business, convert to or expand use of information technology, etc.

________________________________________________________________________________________

________________________________________________________________________________________

39. Give the name of a current or former independent CPA.

________________________________________________________________________________________

a. Describe any disputes over accounting matters.

________________________________________________________________________________________

________________________________________________________________________________________

40. Describe any apparent problems or areas for improvement that were noted where our firm could provide additional service or recommendations.

________________________________________________________________________________________

________________________________________________________________________________________

41. Is the client relatively free from controversy and media coverage?

________________________________________________________________________________________

________________________________________________________________________________________

Independence

42. Would service to this client cause problems of independence or conflicts of interest because of relationships with other clients or members of the staff?

________________________________________________________________________________________

________________________________________________________________________________________

Fees

43. Based on inquiries with a current or former independent CPA, if applicable, indicate the amount of any unpaid fees and the reason for nonpayment.

________________________________________________________________________________________

________________________________________________________________________________________
44. If possible indicate the amount of fees charged by an existing or former independent CPA for the service being proposed. (The CPA or the potential client may be willing to furnish this information, or it might be obtainable from the financial statements or tax return.)

45. Describe any other indications that our firm might have a problem billing or collecting our fees.

46. Does the prospective fee justify pursuing this engagement?

Management Integrity

47. Have any of the following sources raised any concerns about management's integrity?
   a. Difficulty in obtaining information from management, or evasive, guarded or glib responses to inquiries.

48. If management is changing accountants, why is the change being made, and is the reason for the change acceptable?

49. Is there any reason to suspect that management would be uncooperative, unreasonable or otherwise unpleasant to work with?

50. Does the general integrity of the client seem satisfactory?

Other Comments or Observations

51. Give any other comments or observations that might affect our decision whether to prepare a proposal letter or its contents. Add attachments to this form, if necessary.

Conclusion

52. Should we accept/continue this client/engagement?
## Summary Control Checklist

**Firm Name**

**Quality Control Monitoring System Summary**

**Year Ended ————**

<table>
<thead>
<tr>
<th>Monitoring Procedure</th>
<th>Reviewed</th>
<th>Location of Documentation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Analysis of the relevance of new professional pronouncements</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Continuing professional education and other professional development activities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Independence confirmations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Client/engagement acceptance and continuation decisions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interviews of firm personnel</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Review of engagements</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inspection (describe procedures performed)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other procedures (describe)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Determine that the above procedures have adequately considered and evaluated:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. The firm’s management philosophy.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Its practice environment.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. The relevance and adequacy of firm policies and procedures.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Compliance with firm policies and procedures.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Appropriateness of the firm’s guidance materials and practice aids.</td>
<td></td>
<td></td>
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<tr>
<td>6. Effectiveness of professional development activities.</td>
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<td></td>
</tr>
</tbody>
</table>

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.20 Summary Monitoring/Inspection Report

I. Planning the Inspection

A. Inspection period

B. Composition of Inspection Team:
   1. Captain Position
   2. Team Member Position
   3. Team Member Position

C. Indicate matters that may require additional emphasis in the inspection and explain why.

D. Development of Inspection Program:
   1. Describe programs used and indicate any deviations therefrom.

D. Development of Inspection Program:
   2. Describe basis for selection of engagements:

E. Timing of Inspection:
   Commencement
   Completion of work
   Issuance of report

II. Scope of Work Performed

A. Indicate elements of quality control not addressed and give reasons.
### B. Engagements Reviewed:

<table>
<thead>
<tr>
<th>Audits:</th>
<th>Firm Totals</th>
<th></th>
<th>Engs. Reviewed</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Hrs.</td>
<td>No. of Engs.</td>
<td>Hrs.</td>
<td>No. of Engs.</td>
</tr>
<tr>
<td>SEC Clients</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Government</td>
<td></td>
<td></td>
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<tr>
<td>ERISA</td>
<td></td>
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<tr>
<td>Other</td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Reviews</td>
<td></td>
<td></td>
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<tr>
<td>Compilations</td>
<td></td>
<td></td>
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<tr>
<td>Attestations</td>
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<tr>
<td>Other Accounting Services</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

Comments:

________________________________________________________________________________
________________________________________________________________________________
________________________________________________________________________________

III. Engagement Conclusions

A. Did the inspection disclose any situation that led the reviewers to conclude that the firm or office should consider:

1. Taking action to prevent future reliance on a previously issued report, pursuant to SAS No. 1 (AICPA, Professional Standards, vol. 1, AU sec. 561)?

   Yes ____________  No ____________

2. Performing additional auditing procedures to provide a satisfactory basis for a previously expressed opinion, pursuant to SAS No. 46 (AICPA, Professional Standards, vol. 1, AU sec. 390)?

   Yes ____________  No ____________

B. Did the inspection team conclude in any instances that the firm or office lacked a reasonable basis under the standards for accounting and review services for the report issued?

   Yes ____________  No ____________

If any of the answers above are yes, attach a description of such situations, including actions the firm or office has taken or plans to take.

IV. Findings and Recommendations:

Attach a copy of any reports issued, including a summary of any inspection findings and recommendations for improvement or list such findings and recommendations below.

________________________________________________________________________________
________________________________________________________________________________
________________________________________________________________________________
________________________________________________________________________________

Supervisory Partner ____________________________
Date ____________________________

---

2 Includes only audits conducted pursuant to the Government Auditing Standards, issued by the Comptroller General of the United States ("Yellow Book").
**Note:** A firm should make the analysis and assessment of the relevance of new professional pronouncements that can affect its practice, and consequently its quality control system, an ongoing activity. The AICPA’s *Journal of Accountancy* publishes many of the new pronouncements in its Official Releases column. Thus, a practitioner can review the new pronouncements monthly (or after tax season for the first three months of the year) and record that review on a checklist similar to the one below.

<table>
<thead>
<tr>
<th>Professional Pronouncement</th>
<th>Effective Date</th>
<th>Reviewed</th>
<th>Relevant</th>
<th>Comment, Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Auditing Standards</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Statement on Auditing Standards No. 94, <em>The Effect of Information Technology on the Auditor’s Consideration of Internal Control in a Financial Statement Audit</em></td>
<td>Audits of financial statement for periods beginning on or after 6/1/01</td>
<td></td>
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</tr>
<tr>
<td><strong>Attestation Standards</strong></td>
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<tr>
<td><strong>Auditing Interpretations</strong></td>
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<tr>
<td><strong>Attestation Interpretations</strong></td>
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<tr>
<td><strong>Standards for Accounting and Review Services</strong></td>
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<td></td>
</tr>
<tr>
<td><strong>Other AICPA Official Releases</strong></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Statement of Position 01-2, <em>Accounting and Reporting by Health and Welfare Benefit Plans</em></td>
<td>Financial statements for plan years beginning after 12/15/00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Other Professional Pronouncements</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Office of Management and Budget Circular A-133, <em>Audits of Institutions of Higher Education and Other Non-Profit Institutions</em></td>
<td>Years ending on or after 6/30/97</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Professional Pronouncement</td>
<td>Effective Date</td>
<td>Reviewed</td>
<td>Relevant?</td>
<td>Comment, Reference</td>
</tr>
<tr>
<td>-----------------------------</td>
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<td>-----------</td>
<td>--------------------</td>
</tr>
<tr>
<td><strong>Financial Accounting Standards Board</strong>&lt;br&gt;Statement No. 139, <em>Rescission of FASB Statement No. 53 and amendments to FASB Statements No. 63, 89, and 121</em>&lt;br&gt;Years beginning after 12/15/00</td>
<td></td>
<td>No</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Governmental Accounting Standards Board</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Other Pronouncements</strong></td>
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</tbody>
</table>

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*[The next page is 20,001.]
AAM TOPICAL INDEX

References are to section and paragraph numbers.

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